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Salford University Business School

Working Paper

Fat Tony goes to the Movies:

Language and the professions, a guide to the roots of financial crises

by

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ABSTRACT

This paper challenges the finance profession's self-proclaimed expertise through an avowedly polemical examination of the most recent financial crisis. It argues that the financial industry projects itself as a profession and, as with all professions, unnecessarily complicates the language and operations of the industry. It contends that by looking closely at the basic concepts of confidence and trust in games, particularly in gambling, through one of the most effective learning mediums available (the movies) it is possible to penetrate the linguistic fog generated by the finance industry. Only by using such a populist medium is it possible to make the industry more transparent and understandable to the financial laity which will, in turn, enable that laity to game the financial industry more effectively.

Introduction

This paper is unashamedly polemical, opinionated, biased, and an irritant designed to potentially produce a pearl of understanding. The power of any analogy does not lie in its inception but in refining that analogy. This paper hopes to generate such refinement through discussion. It also admits the 'fault' of being non-academic although would hope that the 'fault' is actually an advantage.

It takes its lead from von Hayek's 1974 Nobel Prize memorial lecture, *Pretence of Knowledge* in which he admitted the futility of trying to make economics 'scientific' in the accepted sense of the word at that time. However, the paper itself is not rooted in the past as the post-crisis review by the UK's Financial Conduct Authority (FCA) made clear. Tracey McDermott, the director of supervision at the FCA admitted that very little had changed in the behaviour of the big banks (FVC, 2015) since the crisis; that remains the case to this day. The author is not an economist or financier by trade but has spent many years in the gambling industry and finds too many similarities in the behaviour of those who were at the heart of the most recent financial crisis with those in the gambling industry to ignore. The author also believes that the pedagogical power of the movies is underestimated as well as underutilised.

Part I

What's the Story?

Our descendants doubtless will laugh at the insanity of our age.

Theodorus Schrevelius, Dutch writer and poet, commenting on Tulipmania in 1648

In the early days of the financial crisis that he himself described as, “capitalism’s worst crisis since the 1930s”, Daniel Yergin wrote a concise piece in the Financial Times entitled, *A Crisis in Search of a Narrative*, (FT, 21 October 2009, 13). He identified 11 potential narratives (Appendix 1) arguing that, “eventually, what emerges as the dominant narrative will be affected by the speed and the scale of the recovery”. By 2012, Andrew Lo (2012) had concluded, after a review of 21 books written about the crisis, that “no single narrative had emerged”. Only by 2017, were the big economies returning to pre-2008 performance levels after the longest recovery period for more than 100 years; so, it is time to look again for that elusive ‘super-narrative’.

Sadly, it still seems impossible to achieve consensus around a single ‘super-narrative’. For example, the official US government commissioned report on the crisis (The Financial Crisis Inquiry Report) blamed, in no particular order,

- widespread failures in financial regulation and supervision
- failures of corporate governance and risk management at many systemically important financial institutions
- a combination of excessive borrowing, risky investments, and lack of transparency
- a systemic breakdown in accountability and ethics
- collapsing mortgage-lending standards
- the three credit rating agencies were key enablers of the financial meltdown.

Even that report did not achieve consensus because there were dissenting opinions expressed by Keith Hennessey, Douglas Holtz-Eakin and Bill Thomas (appendix 2). The problem was that each separate narrative was merely a symptom and failed to identify the disease.

Despite the fact that no dominant `super-narrative` emerged, there is, and has always been, a `supra-narrative`, the disease itself. This `supra-narrative` not only explains the most recent crisis but also all previous crises from the Tulipmania of 1636/1637 to the South Sea Bubble of 1720 to the dot.com bubble of the late 20th century to the housing bubble cited by the national commission. In this `supra-narrative` there are two tribes. The first tribe genuinely believe that they are smart guys who can see into the future, they can forecast, or at least they convince themselves they can, or they might even lie about their powers. In this tribe live those that Nassim Taleb (2007, xviii) asserts “dress up the intellectual fraud of forecasting with mathematics”. This tribe “smokes you with complicated mathematical models” (Taleb,2007, xx).

While it might be an exaggeration to suggest, as Taleb does, that the finance `experts`, “do not know more about their subject matter than the general population” (2007, xxvii) it is true that they do not know as much as they think they do. In fact, the Nobel Laureate, Daniel Kahneman, thinks that in the forecasting world nobody can *know* the future. In his most recent book he points out that he has,

*“heard of too many people who `knew well before it happened that the 2008 financial crisis was inevitable`. This sentence contains a highly objectionable word which should be removed from our vocabulary in discussions of major events. The word is, of course, **‘knew’**. Some people thought well in advance that there would be a crisis,*

but they did not ‘know’ it. They now say they knew it because the crisis did in fact happen. This is a misuse of an important concept” (2012, 201).

In a strictly literal sense Kahneman is right but in a more ‘homo-sapien’ sense (Thaler, 2000) he is wrong. We *can* know stuff.

Immediately after the 1995 Nick Leeson induced collapse of Barings Bank I was researching, in collaboration with the City of London Police, Leeson’s behaviour. My conclusion at the time was that it would happen again. I *knew* it would but what I didn’t know, of course, was when, how and where it would happen. Similarly, when the 2008 crisis hit I *knew* that it would not dramatically alter the behaviour of either the banks or the traders over the long term. So it came as no surprise that since Leeson we have seen Toshihide Iguchi (1995), Yasuo Hamanaka (1996), John Rusnak (2002), Jerome Kerviel (2008) and Kweku Odoboli (2012) rack up total losses for their employers in the region of \$12 billion.

As for the banks, they have, in the last three years alone, been found guilty of manipulating the LIBOR, the foreign exchange market and the gold market. They have breached sanctions against nations, money laundering regulations and in the United Kingdom alone they have had to pay more than £20 billion in compensation for mis-selling products. In the US the total fines imposed to date amount to in excess of \$135bn. As recently as July 2105 the UK’s Financial Conduct Authority (FCA) issued a report (FCA, 2015) that concluded,

Change has lacked urgency. Overall, the progress to improve oversight and controls around benchmark activities across most firms and within individual firms appeared slow. This lack of urgency is disappointing given the importance of benchmarks to the economy, the similarity and severity of a number of previous benchmark failures, the

high level of public concern as a result of the misconduct made public, and the scale of enforcement fines levied on firms.

In other words, 'not much is changing'.

So, we *can* know overarching truths, we *can* construct a 'supra-narrative'. Interestingly, the quasi-scientific, quants-based forecasting knowledge that the finance sector has claimed to know is the very type of *knowing* that should be resisted the most. To be fair, within the economic community that has actually been happening as far back as Keynes' warnings about 'animal spirits'. Friedrich von Hayek, in his Nobel Memorial Lecture explained that he preferred, "true but imperfect knowledge, even if it leaves much undetermined and unpredictable, to a pretence of exact knowledge that is likely to be false" (1974). The first tribe, the current crop of finance 'experts', clearly suffer from von Hayek's "pretence of knowledge" or what J.K. Galbraith (1990, 87) identifies as "a generation impressed with its own innovative genius".

Bizarrely, the second tribe, the financial laity, despite all the evidence to the contrary, actually believe that the first tribe are the financial experts they claim themselves to be. Galbraith explains that this is the case because, "individuals dangerously captured by belief in their own financial acumen and intelligence are able to convey this error to others" (1990, 51). Unfortunately there is a contagious nature to their self-confidence.

While it is easy to understand how individuals can delude themselves, it may seem more difficult to understand why others should be so easily convinced. Apparently, again according to Galbraith, intelligence is seen to be "derived from association with money" (1990, 41). He further argues that there is "a tendency of the many who live in more moderate circumstances

to presume an exceptional mental aptitude in those who, however evanescently, are identified with wealth” (1990, 88). So, not only does the laity believe the ‘experts’ when they say that they ‘know stuff’ they also intrinsically believe that *any* person of wealth also ‘knows stuff’. For the purpose of this paper the first tribe will be referred to as *the takers* with the second as *the taken*.

Of course, as David W. Maurer explains in his 1940 classic, *The Big Con*, ‘the taken’ are invariably complicit in their own downfall. “A confidence man”, Maurer argues, “prosper only because of the fundamental dishonesty of his victim....In the mad frenzy of cheating someone else, he is unaware of the fact that he is the real victim, carefully selected and fatted for the kill. Thus arises the trite but nonetheless sage maxim: ‘you can’t cheat an honest man’” (1940, 2).

The language of the *taker/taken* relationship is replete with words for both *the takers* (Conmen, Grifters, Sharks) and *the taken* (flounders, marks, suckers, muppets, sheep, chumps, baby seals, lambs). According to Michael Lewis, in *Liar’s Poker* (1989), there was another more sinister term used for the *taken*, it was, ‘customer’. Notwithstanding Maurer’s notion of basic dishonesty and Lewis’ cynicism, what is it that makes *the taken* believe *the takers* version of the future? There appears to be a natural, probably class-based, deference to elite groups, to groups that are able to demonstrate or manufacture a level of authority in a specific discipline. The ‘authority’ syndrome is borne out in various works. For example, in Robert Cialdini’s work on influencing (2000), ‘authority’ is one of the six key elements in influencing people’s decision making. Similarly, Kahneman and Tversky’s early work on heuristics (1974) confirms the power of authority. Both works explain how symbols of authority, particularly professional status, are powerful tools of persuasion.

The most obvious manifestation of such elitist authority can be seen in the professions. Here, exclusivity of membership and language generate authority. As George Bernard Shaw (1911) asserts, “all professions are conspiracies against the laity” because they create and retain bodies of knowledge and expertise for which they are then able to charge high fees simply for its release. This, in turn, engenders a dependency that is an intrinsic element of the business model of the professions. What clearly happened in the finance industry pre-2008 was that, through the use of ever more complex language for what were essentially simple products, the industry presented itself to *the taken* as a profession with all the elitist exclusivity and authority which that entails. With that authority came the attendant suspension of disbelief of the consumers, and perhaps even more disastrously of the regulators and politicians, about the true nature of a deregulated financial sector. The sector had become a gamblers’ paradise which was not surprisingly, dominated by gamblers.

However, be warned, the oft quoted description of the worst excesses of the finance industry as ‘casino banking’ is actually a slur on casinos. Casinos are actually incredibly well-regulated, well managed and profitable. In reality, the finance industry more closely resembled the pre-legalised betting industry in the UK where unregulated bookies effectively ran the world. Financiers, particularly in the investment banks, had simultaneously become both punters and tipsters able to profit from bets and/or advice whether those bets were won or lost. This practice was precisely with what the SEC charged Fabrice Tourre – ‘playing both ends against the middle’. Fabulous Fabrice, as he called himself, created a fabulously complex financial CDO product (Abacus 2007 – AC1) which bundled other products into risk-based packages (tranches), the riskiest of which were linked to sub-prime mortgages. Abacus was betting that the property market would continue to boom while the creator of the

product and Paulson's Hedge Fund, were betting against the boom through Credit Default Swaps. Imagine Tourre was a tipster at the track. He was telling punters that they were betting on a sure-fire winner while he and Paulson knew that the horse had already been nobbled. Investors in the CDO lost \$900m, Paulson won \$1bn and Goldman's took out \$15-20m in structured fees.

PART II

Why Narrative?

Story is far older than the art of science and psychology, and will always be the elder in the equation no matter how much time passes. —Clarissa Pinkola Estes

So, the supra-narrative is clear; there are *the takers*, those who 'know stuff' and linguistically obscure the reality of what they 'know' in complex stories and there are *the taken*, those who believe the stories promulgated by *the takers*, even though they don't understand them. This represents a steady-state with which everyone seems content until a euphoria takes over as both groups catch the same 'this-state-will-continue-forever' virus and, lemming-like, head inexorably towards the cliff's edge.

But why is an understanding of narrative considered so important? Quite simply because Kahneman's 'homo sapiens' are also 'homo narrans' (Niles, 2010) and we interpret our world through narratives (Schank and Abelson, 1995). It is clear that "to be human is to tell stories" (Fisher, 1984). However, most significantly for this paper, is the fact that we *learn* most effectively through stories (Clark, 2010) and the learning is, in turn, located in the reality constructed by the individual. There is, therefore, a symbiotic relationship between the

realities *the takers* construct and the stories they tell themselves; there is also a self-reinforcing relationship between *the takers*' stories and the acceptance of those stories as reality by *the taken*. It's a heady mix.

Combine the human propensity to interpret the world through stories with a finance industry that has a 'pretence of knowledge', add a consumer base that is deferential to the perceived professionalism of the 'experts', season with the ability of the 'experts' to tell great stories, add just a pinch of huge self-confidence and you have the perfect financial storm. Within this perfect storm the opportunities for *the takers* grew exponentially as systemic forces moved in opposite directions. Derivative markets were spawning a variety of synthetic products which made tracing where the final responsibility lay almost impossible. Simultaneously, although the need for robust regulation and supervision was at its greatest, governments were actually relaxing regulations in the belief that markets would self-regulate. Good luck with that.

Nassim Taleb opines that the reason we buy into the stories that financial experts tell is because they're just much better at narrating than the general public (xx). As Kahneman also observes, a "compelling narrative fosters an illusion of inevitability" (200). Taleb's conclusion is that you need a "story to displace a story" (xxvii). However, it is not enough to simply replace one story with another. It is vital that the new story is understood by the financial laity in order to enable the demystification of the linguistic complexity in which simple concepts have been clothed by the 'experts'.

The best guide in this endeavour is Taleb's fictional character Fat Tony. This paper will try to apply Fat Tony's basic 'experience honed by common sense' model of analysis throughout. The medium through which Fat Tony's analysis will be delivered is, the movies. Why the

movies? Because they are a visual representation of a story and are, therefore, as close as we can get to a perfect learning vehicle. They are also completely accessible both linguistically and conceptually. The following example illustrates precisely how challenges to the 'establishment' can be made most effectively using simple language through an accessible medium. In the Eddie Murphy movie, *Trading Places* two commodity broker brothers are explaining how their business works to Eddie Murphy's character, Billy Ray Valentine, a homeless drifter:

Randolph Duke: *Now, some of our clients are speculating that the price of gold will rise in the future. And we have other clients who are speculating that the price of gold will fall. They place their orders with us, and we buy or sell their gold for them.*

Mortimer Duke: *Tell him the good part.*

Randolph Duke: *The good part, William, is that, no matter whether our clients make money or lose money, Duke & Duke get the commissions.*

Mortimer Duke: *Well? What do you think, Valentine?*

Billy Ray: *Sounds to me like you guys are a couple of bookies.*

Randolph Duke: *I told you he'd understand.*

While the movies used to illustrate central truths can be either fictional or documentary for the most effective learning they should be delivered in narrative form. The Shakespearean histories, for example, show how fictionalising factual events can be used to polemical and/or educational effect. While the documentary movie and book, *Smartest Guys in the Room*, was a powerful indictment of the Enron scandal, the play about the scandal by Lucy Prebble was actually much more powerful and ultimately more revealing.

Of course, any movie can be used for educational purposes but there is a certain genre that is most suitable for the development of financial and risk literacy. This genre deals directly with the worlds of gambling and confidence, two elements that underpin every financial crisis. Akerlof and Schiller point out in *Animal Spirits* that “the reason that rational economic theory fails is because it doesn’t take into account the roles of confidence, stories and snake oil in economic fluctuation” (2009, 98). Confidence, stories and snake oil are the very stuff of gambling and confidence movies.

PART III

Experts that ain’t!

Economists are at this moment called upon to say how to extricate the free world from the serious threat of accelerating inflation which, it must be admitted, has been brought about by policies which the majority of economists recommended and even urged government to pursue. We have indeed at the moment little cause for pride: as a profession we have made a mess of things. Freidrich von Hayek, 1974

This next section deals primarily with those members of the *takers* tribe who consider themselves, and are sadly considered by others, to be experts in financial matters; indeed, those who deal in confidence, stories and snake oil. Of course, there *are* experts operating within the financial sector but they tend to be the “the men on the trading floor [who] may not have been to school but have PhDs in man’s ignorance” (Lewis, 1989,). Unfortunately, they also tend to be experts at ‘taking’. They can be the self-delusional, the incompetents, the charlatans, the naïve, the ingénues or the crooks. Fat Tony’s role is to lead a rallying cry

against these experts; to constantly challenge the self-proclaimed experts' predictions with his particularly street-wise brand of common sense.

In the aftermath of the financial sector meltdown Fat Tony didn't have to look very far for any of these intellectual impostors. The most eminent and crestfallen must surely be Alan Greenspan. As the Chairman of the Federal Reserve, Greenspan sold his free-market, EMT inspired, light touch regulation as a certainty. In the film, *Two for the Money*, a film about the world of sports betting tipsters, a multi-million dollar business on US specialist TV channels, the Al Pacino character (Walter Abrams) explains the 'tipster' game to his apprentice, Matthew McConaughey.

Stats are not enough, you need a voice! These are gamblers ready to risk what they can't afford for what they can't have, you're selling the world's rarest commodity: certainty, in an uncertain world. (<http://www.anyclip.com/movies/two-for-the-money/practice-pitch/#!quotes/>)

Nobel Laureate, Robert Shiller, similarly warned against such certainty, "I've always felt that people like to exaggerate their certainty about theories that their ego is involved with. I think something is suspect there when someone has such overwhelming certainty" (Washington Post, 13 October, 2013).

Notwithstanding such warnings, Greenspan maintained his façade of certainty until October 2008 when he admitted that there was 'a flaw' in his thinking, that he wasn't so certain. He did so with two frankly astonishing statements. The first, "I did not forecast a significant decline because we had never had a significant decline in prices"; and the second, when he declared himself to be "in a state of shocked disbelief [at the failure of the] lending

institutions to protect shareholders equity due to their self-interest” (evidence to the House Committee on Oversight and Government Reform, 23 October 2008). The first suggested a mind-set that refused to see a future different from the past; the second is a classic case of either naiveté or self-delusion. He clearly wasn’t the expert he, and others, believed him to be.

Those others included the United States Congress which told Greenspan in 2005 that he had, “made a great contribution to the prosperity of the United States and the nation is in your debt” (Rep Jim Saxton [R., NJ] Greenspan’s appearance before Congress on 3 November 2005). As astonishing as those statements were, an admission he made to Gillian Tett defies belief. He said, “I am not a neophyte – I have been trading derivatives and things and I am a fairly good mathematician but when I was sitting there at the Fed, I would say, ‘Does anyone know what is going on?’ And the answer was, ‘Only in part’. I would ask someone about synthetic derivatives, say, and I would get detailed analysis. But I couldn’t tell what was really happening” (Financial Times magazine, 25th October 2013).

Another of his ‘expert’ colleagues at the Fed, Frederick Mishkin, forecast in 2007 that the banking problems triggered by the stagnation of the US housing market would be a minor blip. A year earlier he had also endorsed the stability of the privatised Icelandic banks in a consultancy document commissioned by the Icelandic Chamber of Commerce in response to critical coverage by the international business media of the unprecedented growth of the Icelandic economy (*Financial Stability in Iceland* by Frederick S. Mishkin and Tryggvi Thor Herbertsson, May 2008). Less than six months later the Icelandic economy collapsed and the banks were nationalized. Mishkin was paid \$124,000 for the report, a fact that he forgot to mention. Asked in an interview in the film, *Inside Job*, if there was a conflict of interest he

simply replied, “I don’t think so”. Shortly after the Icelandic collapse, Mishkin resigned from his role at the Fed. When asked in the film why he had so suddenly resigned he said, “I had to revise a textbook”.

Mishkin, Glenn Hubbard, the Dean of the Columbia University Graduate School of Business, and John Campbell, chair of the economics department at Harvard, all obfuscated throughout their interviews and looked far from the academic or even the intellect purity they claimed to possess when under pressure from the interviewer. As Fat Tony might ask, ‘are these really the guys you want me to trust with my money? I don’t think so’.

These men were experts only in the sense of Locke’s mad men. For Locke these are men,

Who do not appear to me to have lost the faculty of reasoning, but having joined together some ideas very wrongly, they mistake them for truths; and they err as men do that argue right from wrong principles. For, by the violence of their imaginations, having taken their fancies for realities, they make right deductions from them (Locke, 1690, chapter XI).

They all displayed those most toxic of characteristics, they were self-deluding and simultaneously utterly convincing to *the taken* tribe. The ‘madmen’ were not, of course, restricted to the US. Mervyn King, the governor of the Bank of England, stated in May 2008, “It’s quite possible that at some point we may get an odd quarter or two of negative growth. But recession is not the central projection at all” (TV interview on publication of the bank of England’s Quarterly Inflation Report - 14th May 2008).

The evidence, as it emerged, pointed unerringly to the fact that the 'experts' actually believed their own sales pitches. One example being that the banks held onto their own CDOs even though the rationale for their creation had been to sell them. They even lent money to others to purchase CDOs. They were all, in Galbraith's terms, "inferred geniuses" (41). As James Surowiecki put it, "The Bankers Drank Their Own Kool-Aid". He argued that "the reality is that our current problems are more the result of Wall Street's stupidity and recklessness than its corruption (though there was plenty of that)" (article in the New Yorker, 11 February, 2009). John Holmes, a psychology professor states that, "For better or worse, stories are a very powerful source of self-persuasion, evidence that doesn't fit the story is going to be left behind" (Dingfelder, 2011, 42).

Those other so-called experts, the ratings agencies, were also mad. Eric Kolchinsky of Moody's is quoted as saying he was not aware of John Paulson's involvement while Moody's was deciding on the rating of the now infamous Abacus product. "It just changes the whole dynamic - if the person choosing it, wants it to blow up", he said (Financial Times, 24th/25th April 2010). Kolchinsky was the MD of the Moody's unit responsible for rating sub-prime backed securities. Moody's actually rated Lehman Bros. as A2 and AIG as Aa only days before each company collapsed. That means that the companies were 'judged to be of high quality and are subject to very low credit risk'.

Similarly, independent financial advisers (IFAs) were found not to be very independent. In their research on financial advice, Mullainathan et al found that, "advisers fail to de-bias their clients and often reinforce biases that are in their [own] interests....They encourage returns chasing behaviour and push for actively managed funds that have higher fees, even if the client starts with a well-diversified, low fee portfolio"(2012). Fat Tony would be surprised

that anybody was surprised. He would have been even less surprised that 27% of IFAs refused to give any advice at all unless the clients agreed to transfer their portfolios.

The ratings agencies and IFAs were only part of an entire industry riding on a wave of 'inferred genius'. The hedge fund 'experts' were also less than expert. For example, HedgeFundResearch.com found that between 2010 and 2013 more than 85% of hedge funds failed to match the market. So, how do these experts convince us to trust them? Alistair Milne, in his excellent 2009 take on the crisis, explains the reasons very clearly. He says that,

Our current global financial situation is not really that complicated or difficult to understand. Bankers have often preferred to conduct their business in as sophisticated and roundabout a way as possible. That way, it is not too clear when they are doing a good or a bad job; they can charge high fees and not be too worried about competition from other professionals doing the same task just as well for a smaller fee; nor, then, do they have to be too concerned about customer complaints, because few customers can tell whether they are getting good value or not (2009, 6).

Cheng et al similarly found "little evidence of the securitisation agents' awareness of a housing bubble and impending crash in their own home transactions... and neither managed to time the market nor exhibited cautiousness in their home transactions" (2013). Again, the experts weren't.

A large part of the complexity is generated by the language used by financiers and, indeed, all professions. For the professions the mantra of, 'from the simple to the complex' is reversed. Over recent years that reversal has become even greater. The relatively simple Glass-Steagal Act lasted more than 60 years without much amendment; Basel is already in its third iteration

and has grown from 30 to 616 pages in less than 12 years. The incestuous linguistic relationship between the professionals and the media only adds to the exclusion of *the taken*.

A recent book by John Lancaster encapsulates the problem of overly complex language in its title, *How to Speak Money*. Lancaster points out that “there is a huge gap between the people who understand money and economics and the rest of us...The language of money is a powerful tool and it is a tool of power. Incomprehension is a form of consent” (2014). He is correct. And the power of language should not be underestimated. Research by Professor Michael Morris of Columbia University has shown, for example, that the use of agent metaphors in the media when reporting stock prices significantly affects the way in which investors perceive the future movement of the stocks. “Agent metaphors, compared with object metaphors and non-metaphoric descriptions, caused investors to expect price trend continuance” (2006); and the same phenomena appeared to be true with the language used in company reports. In an essay in the magazine *Prospect*, John Kay a visiting Professor of Economics at the London School of Economics, explained how powerful the use of metaphor can be in cutting through the pretense of knowledge. Kay explained how,

The metaphor of the casino invites both citizen and the saver to treat financial services with less deference and respect. Bookmakers are prosperous, but most people regard them as slightly ridiculous. Their prosperity is the product of human frailty, deep cynicism indispensable to their success. Not many decades ago, stockbrokers, though drawn from a different social stratum were regarded in much the same way. This is probably how it should be (2009, 58).

The concepts of ‘inferred genius’ and the ‘pretence of knowledge’ will eventually bring the house down. As Taleb points out, “an overconfident pilot will eventually crash the plane.

And numerical prediction leads people to take more risks” (2010, 167). In the lead up and indeed after the crisis the `experts` were overconfident and took more risks – and they brought the house down. The need to be seen as the smartest guys in the room is as significant a factor as the need to make money.

Of course, `experts` are essential to any human endeavour but they must never be implicitly trusted to provide either expert or unbiased advice. As David Mamet warns,

The poker player learns that sometimes both science and common sense are wrong; that the bumblebee can fly; that, perhaps, one should never trust an expert; that there are more things in heaven and earth than are dreamt of by those with an academic bent (1986).

The key to understanding who the `experts` really are and what they really know, is to understand the underlying nature of the industry in which they operate and the financial sector needs to be seen for what it is, a risky business.

Part IV

Finance as Gambling: it's a matter of confidence

The gambling known as business looks with severe disfavour on the business known as gambling. Ambrose Bierce, "The Devil's Dictionary" (1906)

It has become something of a cliché to compare gambling and trading but that does not make it any less accurate. To gamble is to put something of value at risk on an uncertain outcome. In his book, *The Poker Face of Wall Street*, Aaron Brown (2006) confirms that the Ambrose Pierce theory quoted above is alive and well in the 21st century. Brown states that, “Gambling

lies at the heart of economic ideas and institutions, no matter how uncomfortable many people in the financial industry are with the idea” (2). In her 2006 article Christine Hurt similarly confirms the relationship between *the takers* and *the taken* in both gambling and trading and proposes that such a relationship is actually essential to the smooth running of the system:

The utility of the.... stock trading market, and the sports betting market, seems to be to allow professional bettors to profit at the expense of amateurs. The argument that trading provides liquidity in the market becomes a euphemism for the need to have a sucker on one side of every bet. Perhaps the SEC encourages retail investing for the same reason that casinos encourage amateur gamblers to participate. A truly efficient stock market would not produce large profits for any investor. However, reckless investors provide arbitrage opportunities for professional investors. Without reckless investors, the profits to be made in the capital markets would be much smaller. In addition, the financial services industry makes money on every trade through a paid commission, whether the trade is foolish, inspired, or informed” (392).

Indeed, in the immediate aftermath of Tulipmania the courts refused to rule in favour of sellers trying to enforce contracts for sale on the grounds that it was a “gambling operation” (Galbraith, 1990, 33).

Not only are the games of finance and gambling analogous but the skill sets are also identical. Skills that define successful traders such as a cold-blooded approach toward risk, speedy decision-making under pressure, discipline and a well-trained memory are the same ones that separate elite poker players from the rest. Brandon Adams, a professional card player who has also taught a class in behavioural finance at Harvard, argues that some of the best traders are the professional online card players. “They’ve essentially been the survivors in the

system, a very difficult system where 95% of people lose money. Anyone smart enough and disciplined enough to survive that system is probably going to do very well in the trading world” (Bloomberg website, 20 November, 2009). Similarly, Aaron Brown, the former professional poker player and risk manager at AQR Capital Management LLC, believes that, “Someone who has made a successful living as a poker player for a few years would more likely be a good trader than someone who hasn’t. They know to push when they have the edge and they know how not to bust, and that’s a tough combination to find” (<http://www.businessinsider.com/wall-streets-best-poker-players-2011>).

To actually win at poker entails attention to detail while simultaneously expecting the unexpected. In von Neumann’s early work on Game Theory he tried to model poker, but soon discovered that “actual poker is really a much too complicated subject” (1944, 136) and the sheer complexity of the game was not conducive to mathematical modelling, especially since at the time the necessary processing power did not exist. Similarly, no purely analytically-based forecasting can describe free-market economies. For any analytical model to work, in poker and/or the financial markets humans would have to be predictable. Von Neumann immediately recognized and admitted that, “Real life consists of bluffing, of little tactics of deception, of asking yourself what is the other man going to think I mean to do, and that is what games are about in my theory”(von Neumann, 1944, 136). However, since von Neumann’s time processing power has increased exponentially and the best players now combine big data insights with a gambler’s intuition. Nevertheless, seasoned gamblers still argue that although you have to “have a feel for game theory ...psychology trumps game theory: dominating people at their moments of weakness in the tournament, getting to them [is what counts]” (Howard Lederer quoted in the Financial Times magazine, 6/7 May 2006).

It seems, therefore, that the link between gambling and the finance sector is irrefutable. In fact, the only possible argument against the model of finance as gambling is that professional gamblers are far more professional than their finance counterparts. A 2011 study by Leavitt and Miles (2011) proved conclusively that poker is a game of skill while conversely there does not appear to be similar evidence in favour of asset managers. The research revealed that 'high skilled' poker players achieved an average of 30.5% ROI whereas the 'others' made an average loss of 15.6%. Crucially, the report pointed out that in similar experiments with asset managers there was "little evidence of skill in this domain, as demonstrated by the low rates of persistence in mutual fund returns" (13).

Two of the key elements of gambling, bullying and bluffing, are the subjects of recent research by Nobel Laureate, Robert Shiller. In his forthcoming book, *Phishing for Phools*, he and his co-author George Akerlof, deliver a fundamental challenge to EMT by arguing that as long as there is profit to be made, sellers will systematically exploit our psychological weaknesses and our ignorance through manipulation and deception. Rather than being essentially neutral and benign, markets are inherently filled with tricks and traps and will 'phish' us as 'phools'.

Central to any manipulation and deception is the role played by confidence and its dangerous partner, overconfidence. Any content analysis of finance and gambling literature is replete with the word 'confidence'. In *Animal Spirits*, Akerlof and Shiller proposed five key psychological factors the most important of which was confidence (or lack of it) in the economy and one's personal place in it. The problem is that while confidence is essential to raise the billions needed to fuel modern industry it is also an essential tool with which to fool the 'taken'. It is the unpredictability of individual and group confidence that injects volatility

into the financial markets and which, with the best will in the world, cannot be measured or modelled.

Of course, when confidence is mentioned in relation to finance what is actually being discussed is overconfidence. The fact is that we become over confident as a consequence of the stories we tell ourselves about the past. As Daniel Kahneman points out, “overconfidence is fed by the illusory certainty of hindsight....and we are prone to overestimate how much we understand about the world and to underestimate the role of chance in events” (2011, 14). Earlier research by Odean and Barber identified a “simple and powerful explanation for the high levels of counterproductive trading in financial markets: overconfidence” (2001, 289). They further argue that human beings are innately overconfident about their abilities, their knowledge, and their future prospects and also that men are more overconfident than women. That particular difference in overconfidence yields two predictions: “men will trade more than women, and the performance of men will be hurt more by excessive trading than the performance of women” (2001, 261). In other words men act on their own assessment of their own ability much more often than do women. The result is that women tend to achieve better investment results than men. Ironically, a certain level of overconfidence might be essential to trading. As Kenneth Rogoff, the Harvard economics professor, points out that “it is difficult to make a living [on Wall Street] as a mega-bear” (Quoted in the Financial Times, 16 December 2008).

The confidence trickster understands and depends upon our basic biological need to trust each other. Only now are economists catching up with the acumen of conmen and salesmen in recognising how central the connection between confidence and trust is. As Robert Cialdini points out, we are only just beginning to understand how great salesmen operate.

They use reciprocal trust as a powerful tool. We are programmed to trust others especially if we are trusted. This is why Cialdini argues that the “most potent of the weapons of influence around us – is the rule of reciprocation” (2000, 20) which means that you must provide a favour at the earliest stage of a relationship which in turn immediately makes the recipient indebted.

We also now know from the work of scholars such as Paul Zak (2012) that oxytocin, a neuropeptide hormone, plays a key role in substantial increases in trust. We also know that testosterone can be the driver of market manias and that cortisol can inhibit risky behaviour. Traders making money are simultaneously making testosterone in a self-reinforcing cycle just as traders on a losing streak are creating greater levels of cortisol. Finally, we know that the enzyme, monoamine oxidase (MAO) is closely related to risk behaviour. MAO is a regulator, the higher the presence of MAO, the lower the risky behaviour. MAO is higher in women than in men and higher as we age. If you really want risky behaviour on your trading floor then employ young men. Conversely, if you really want conservative behaviour then middle-aged women might be the answer.

The problem is that merely knowing this doesn't help very much. However, knowing that such levels of inconsistency in human behaviour are so prevalent should make us more sensibly sceptical. Paul Seabright, a Professor of Economics at the University of Toulouse has even argued that the need to trust has evolved in the modern economy to such a point that “people give complete strangers sums of money they would not dream of entrusting to their next door neighbours” (Quoted in a Financial times special report, 24th January 2009). Such behaviour is in full view in movies, and more recently on TV shows, which deal with the confidence game (e.g. American Hustle) and deception (e.g. Now You See Me).

Part V

Let's Go to the Movies

You know what your problem is, it's that you haven't seen enough movies - all of life's riddles are answered in the movies.

Steve Martin

The idea of using movies to help understanding complex issues is, of course, not new. The economist and former adviser to Ronald Reagan, Laurence Kotlikoff, used the 1946 movie, *It's a Wonderful Life*, as the basis for his recommendation for 'limited purpose banking' which encompassed all financial institutions. He reasoned that the natural injustice of the system whereby irresponsible or immoral bankers got to bet using *other people's money* is at the centre of the problems of the financial sector. Interestingly, the classic 1914 Brandeis work was also entitled, *Other People's Money* and warned of the rise of the very financial oligarchies that now dominate the financial sector. To complete the movie connection, the 1991 Danny DeVito, Gregory Peck movie was also entitled *Other People's Money* and it contains one of the most precise and accessible explanations of the cultural dilemmas of capitalism.

There are regular magazine articles in which business leaders are asked to name movies which have inspired and educated them. Lessons for *the taken* are best learned from movies which deal with gambling and/or confidence. For example, David Mamet's directorial debut, *House of Games*, is a master class in the function of confidence in any relationship. This movie contains a single line that explains absolutely the confidence relationship. In the movie a psychiatrist (Lindsay Crouse) is researching the confidence game and asks to observe a

confidence trick in action. Mike (the conman played by Joe Montagna) explains the essence of the confidence game, “Why do they call it a confidence game? Because you give me your confidence? No, because I give you mine”. That single sentence is laser like in identifying the power of the financial ‘experts’. They give you their confidence irrespective as to how justified that confidence might be. In a scene that lasts only 3 minute 27 seconds Mike also manages to demonstrate each of the six influencing techniques identified by Robert Cialdini in his work on influencing, confirming Akerlof and Shiller’s ‘deception and manipulation’.

Interestingly, a long-con movie, *The Sting*, was inspired by David Maurer’s book, *The Big Con* mentioned earlier in this paper. In that book Maurer points out that the ‘experts’ belief in their own superiority can actually be used against them by the con artist. Almost all of Bernie Madoff’s victims believed in their own financial superiority. It is wrong, therefore, to assume that the con artist is only an inhabitant of the underworld. In Herman Melville’s final novel, *The Confidence-Man (1857)*, the reality of the con artist as omnipresent in society is made clear by his appearance as a real estate agent, a doctor, a butcher and even as a charity worker. For Melville, the confidence game of constantly shifting moral positions was a central symbol of American cultural history. In the introduction to the paperback edition of the novel, Professor Tony Tanner says that, “the confidence-man is of quite special – and central – importance in American culture and history” (Melville, 1857, xiii). Other movies that illuminate the confidence factor for good, *Coach Carter*, for bad, *Boiler Room*, or for the ambivalent, *Elmer Gantry*, also demonstrate the power of the movie.

In the realm of gambling movies, the final showdown in the Cincinnati Kid illustrates the utter despair of the McQueen character when he realises he has not beaten ‘The Man’ (Edward G. Robinson). That moment is as powerful as the desperate depiction of a gambler

in Dostoyevsky's *The Gambler* (1867). Similarly, a single comment by James Caan in a movie based on Dostoyevsky's novel reveals the delusional world of the gambling addict precisely. He is warned by his girlfriend not to go back to the casino after he'd had a big win, she says, "Don't go back, you'll lose it all". Caan responds, "I'm not going to lose it. I'm going to gamble it".

There are many movies which deal with gambling such as *21*, *Rounders*, *Croupier*, *The Color of Money* and all of them provide insights into the gambler's mind. While some of these movies are great in themselves there is no suggestion that they all are. However, they do all contain lessons about gambling/trading that are more accessible, more easily absorbed and understood than any academic or 'expert' treatise. How much easier is it to actually *feel* the emotional high of a gambler on a rush as performed by James Caan than it is to *feel* the explanation of the same phenomenon as described by even the best of authors in this field such as John Coates (Coates, 2013).

The fiction that we encounter in movies is the medium through which we can most simply understand and more importantly order our realities. This is not a judgement of movies over literature but a judgement about the accessibility for the financial laity to truths about 'the gambling known as business'. The accessibility of movies should not be underestimated and their popularity should not be used as an intellectual barrier to serious debate about issues of central importance to the financial sector.

Part VI

What Now?

The basic elements of the most recent financial crisis are the same as all previous crises – easy money is suddenly available throughout the system primarily as a consequence of innovative financial products; asset prices are then perceived as inexorably rising despite the reality of their actual speculative nature; overconfidence flows which fuels further speculation and then one day, someone, somewhere, loses confidence and blows down the whole house of cards. Reality and perception have collided.

Is there hope that future crises can be avoided simply by the *taken* understanding that the *takers* are trying to take them? Possibly, yes. The hope lies in encouraging a 'why' generation; a generation that crosses social strata and challenges the perceived wisdom of the professionals and 'experts'. One of the reasons that Fortune magazine voted Enron the most innovative company in the US for six years running from 1995 was that in the DNA of the organisation was the 'Ask Why' philosophy celebrated in the company's logo. The Enron genius was to constantly question: why couldn't the company trade gas instead of simply transporting it; why couldn't it become a one-stop energy supermarket providing services to the industry as well as the commercial and retail sectors; why couldn't it develop Enron Online, an idea for an internet-based trading operation eventually used by almost every energy company in the US? Jeff Skilling created an innovation machine. He hired young, smart and entrepreneurial traders and managed them creatively. Of course, then it all went wrong. To understand how that happened watch *Enron*, the play, the movies *Smartest Guys in the Room* and *The Wolf of Wall Street*. Hubris eventually kills but the questioning and challenging of the status quo should not be a casualty of that hubris.

The *taken* must educate themselves to the ways of the *takers*, they must release the Fat

Tony's hiding in their psyches and constantly challenge the 'experts' be they con artists, advisers, academics, regulators, professionals or crooks. If all else fails then heed this final piece of advice from J.K. Galbraith,

When there is a claim of unique opportunity based on special foresight [by self-ascribed geniuses], all sensible people should circle the wagons; it is time for caution (1990, 109).

or on a slightly more prosaic Fat Tony type assessment,

If you ain't just a little scared when you enter a casino, you are either very rich or you haven't studied the games enough (VP Pappy; a legendary Detroit gambler).

The list of movies referenced throughout the paper is, of course, not exhaustive. Add your own, get your students, employees, family and friends to add theirs. It doesn't have to be a great movie just a great scene that contains an easy to understand key lesson; like this one from *Absence of Malice*,

Sally Field: *My Dad was an investment banker.*

Paul Newman: *So was mine, but he was called a loan shark. It must be different though because he did time.*

Notwithstanding all of the above, the ultimate responsibility for being *taken* lies mostly with the rarely mentioned 'culpability of the buyers' (Galbraith, 1990, 86). The best advice for buyers is to watch, and learn from, more gambling/confidence movies, to insist that 'sellers' simplify their language in any financial discourse and finally, to employ their own Fat Tony to challenge and constantly, ***ask why***.

Appendix 1

Yergin's eleven potential narratives:

1. Too much leverage.
2. Rapid and uncontrolled innovation of financial instruments.
3. Inadequate regulation of 'shadow banking'.
4. Aggressive promotion of home ownership.
5. High indebtedness.
6. The balance between fear and greed shifted in favour of greed.
7. Easy credit.
8. Hubris.
9. Global syndication of debt.
10. Spiking commodity prices.
11. The market system is simply destined to crisis.

Appendix 2

THE TEN ESSENTIAL CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS, pp 417-419;

Dissenting Opinions by Keith Hennessey, Douglas Holtz-Eakin and Bill Thomas.

The following ten causes, global and domestic, are essential to explaining the financial and economic crisis.

- I.** Credit bubble.
- II.** Housing bubble.
- III.** Non-traditional mortgages.
- IV.** Credit ratings and securitization.

V. Financial institutions concentrated correlated risk.

VI. Leverage and liquidity risk.

VII. Risk of contagion.

VIII. Common shock.

IX. Financial shock and panic.

X. Financial crisis causes economic crisis.

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