The Impact of the Unknown, on the Unknown

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The Black Swan introduces the concept of negative skew and how businesses and decision-making in general can be approached from a perspective that involves measuring the consequences to the business as it is exposed to all states of the world, irrespective of how improbable some states are.

The classic example is that of an option buyer and an option seller. Simply, the option buyer is more robust to the impact of the unknown since his downside is clipped and his upside is potentially unlimited. On the other hand, the option seller faces an infinite downside and a clipped upside.

The payoff (P&L) parameter on the options shows the positive and negative skew in each of the cases above.

However, this business of ranking businesses based on their "skewness" and exposure to the unknown depends on identifying parameters that are exposed to the Black Swan in the first place. Consider any business that we consider positively skewed, such as a publishing business. Publishing is clearly positively skewed since there is little to lose from each book and the costs are well understood and limited. The potential upside is enormous if for some unknown reason a book takes off. In this case revenue (or profits) is the positively skewed parameter.

A very legitimate question is:

"What if there is an as yet unknown parameter in the publishing business that is negatively skewed?"

OR

"What if there is an as yet *unimagined* parameter in the publishing business that is negatively skewed?"

Thus the unknown is being invoked on the very parameter whose behavior under the unknown needs to be measured.

The answer to this question is unknowable (since there are an infinite number of unknown parameters, and the problem of induction prevents us from knowing when we're done), but does it help us in decision-making?

The idea of skewness helps us in decision-making by prescribing that we *never risk what we cannot afford to lose*. So the original question brings up another question:

"What if we don't know what we don't want to lose?"

This is a very real problem in the real world, where we are hampered by our often limited imagination. However it is solvable, since we can probably agree that we have a finite set of assets that we would never want to lose.

So the first step in this sort of decision-making is to list all the assets that we are not willing to lose completely. These may include different things for different people. I believe this is a straightforward exercise and is certainly doable after a little bit of introspection.

Now let's return to the original question: the impact of an unknown negatively skewed parameter in publishing, that is tied to any of these assets that we don't want to lose.

Unfortunately, that question applies to all possible business choices including all the ones we consider negatively skewed already. Other than the fact that it encourages us to go through as many convoluted imaginative scenarios as possible in the finite time we have before acting (remember, we are in the real world), it does not provide a handle on any criteria to help in decision-making in the real-world. It applies to all businesses and is thus useless in the face of *acting* under uncertainty.

The only thing we can do is put maximum effort in imagining as many parameters as possible (scenario analysis) and focus on avoiding known negatively skewed parameters.

To be continued as discussions wrap up and if I don't go insane as the unknowns keep cascading.