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THE WALL STREET JOURNAL.

WSJ.com

NOVEMBER 3, 2008

October Pain Was 'Black Swan' Gain

By SCOTT PATTERSON

For most of October, it seemed nearly everything that could go wrong with the markets did. But the rout turned into a jackpot for author and investor Nassim Nicholas Taleb.

Mr. Taleb last year published "The Black Swan," a best-selling book about the impact of extreme events on the world and the financial markets. He also helped start a hedge fund, Universa Investments L.P., which bases many of its strategies on themes in the book, including how to reap big rewards in a sharp market downturn. Like October's.

Separate funds in Universa's so-called Black Swan Protection Protocol were up by a range of 65% to 115% in October, according to a person close to the fund. "We're discovering the fragility of the financial system," said Mr. Taleb, who says he expects market volatility to continue as more hedge funds run into trouble.

A professor of mathematical finance at New York University, Mr. Taleb believes investors often ignore the risk of extreme moves in the market, especially when times are good and volatility is low, as it was for several years leading up to the current turmoil. "Black swan" alludes to the belief, once widespread, that all swans are white -- a notion that was proven false when European explorers discovered black swans in Australia. A black-swan event is something that is highly unexpected.

Assets under management at Universa have neared \$2 billion since the fund launched early last year with \$300 million under management. While Mr. Taleb frequently consults with Universa's traders, the Santa Monica, Calif., fund is owned and managed by Mark Spitznagel, who worked for several years in the 1990s as a pit trader on the Chicago Board of Trade.

To execute its strategy, Universa buys far-out-of-the-money "put" options on stocks and stock indexes. These are bets that the market will see a sharp, sudden downturn. They become extremely valuable in a market decline of 20% or more in a one-month period.

When times are good, such options are cheap and Universa gobbles them up, taking small losses along the way. When the market makes a quick, steep turn south, as it has recently, Universa's positions gain value as investors scramble to protect themselves in the downturn by buying puts. The strategy, which keeps more than 90% of assets in cash or cash equivalents such as Treasury bonds,

either breaks even or loses small amounts in most months while waiting for periodic, infrequent spikes in volatility.

Here's an example of a trade the fund made recently. In late September, when the Standard & Poor's 500-stock index was trading around 1200, Universa purchased put options that would pay off if the index fell to 850 by late October. Since such a plunge was considered highly unlikely, such options cost only 90 cents. On Oct. 10, those options cost \$60 as the S&P 500 tumbled sharply. Universa sold most of its position in the high-\$50 range.

Universa also purchased a number of puts on financial stocks, such as [Goldman Sachs Group Inc.](#) In late July, it paid \$1.29 apiece for options on [American International Group Inc.](#), the insurance giant that by September was on the brink of bankruptcy. The puts were priced to pay off if AIG dipped below \$25 a share by September. Universa eventually sold them for about \$21 apiece.

The fund has "done what it was supposed to do for us," says John Salib, a partner at Landmark Advisors, a New York fund that invests in other hedge funds and that invested in Universa in July. "We wanted to protect our portfolio against this kind of environment."

Mr. Taleb made his first killing on Black Monday, the crash of Oct. 19, 1987, as a trader with the investment bank First Boston (now a part of Credit Suisse), with a large position in out-of-the-money Eurodollar contracts. Investors fled into the highly liquid contracts as the market crashed, causing their value to surge.

While the black-swan strategy has paid off handsomely this year, it hasn't always. Mr. Taleb's previous fund, Empirica Capital, which used similar tactics, shut down in 2004 after several years of lackluster returns amid a period of low volatility. The strategy may face another test after the current bout of market turmoil.

The task for the fund's managers is to persuade clients to stick around after their big gains. Historically, such dramatic downturns have been rare events, occurring only once or twice a decade.

Mr. Spitznagel cautions against optimism. "You could say that so much value has been destroyed that there just isn't much left," he said. That is "a dangerous assumption, since things can always get worse."

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