Intelligence Without Understanding

It is man’s nature to want to see patterns where none exist. We strive for certainty in an uncertain world. We value formulas and beliefs over randomness. We think there is always a solution to every problem.

It is our aversion to randomness that put our financial system on the edge of catastrophe. The difference between randomness and risk is that risk carries some degree of certainty if the history and sample size is large enough.

Our obsession with finding patterns may explain the Shroud of Turin, and it explains the deadly popularity of the Gaussian copula function. The academic sounding mathematical model attempted to explain correlations between unrelated financial factors. It became so widely accepted in the world financial circles that it gave comfort to institutions to take exceptional risks.

But the heart of the problem lies not with one who discovered the model, but with the industry leaders who replaced a philosophical understanding of risk with delusional mathematical certainty. They thought that you could create a sound financial product by packaging hundreds and thousands of unsound products together. The mathematical wiz kids did not understand the products and the actual risks behind the numbers.

One of the most outspoken voices over the last few years against the ludicrous mathematical models and the housing and banking bubble was Nassim Taleb, a successful trader and author of “Fooled by Randomness” and “The Black Swan.” Taleb spends more of his time explaining philosophy and its insight into risk than he does with extravagant mathematical models

with names like “Gaussian copula”, though I do not doubt he understands the mathematical concepts far better than most of its practitioners.

Certainty comes at a high cost. With an extravagant enough formula we can believe that the fundamental laws of math change when the numbers get large enough. It is critical that we gain an understanding beyond mathematical illustrations. After the decade of greed in the 1980’s we demanded ethics courses in the business schools; we should have demanded philosophy courses.

Intelligence does not equal understanding. A farmer understands the philosophical concept of sewing and reaping far better than the commodity trader selling his products and the bureaucrat regulating his industry.

Mere intelligence does not overcome the human desire for certainty and patterns; it often descends into the arrogance of believing we can provide certainty and answers where none exist.

We did not arrive at our crisis from the lack of intelligence, but from blind faith in an intelligence that often runs counter to common sense and understanding. You have to be pretty smart to screw up this big.

Just as blind faith in a delusional intelligence got us into this mess we should equally eschew blind faith in the political solutions to restore stability. I remain skeptical about blind faith in any leader whose main qualification is a perceived intelligence, but who lacks the experience that promotes understanding.

Intelligence without understanding will only deepen the hole.