



CHAPTER 1

The Art of Uncalculated Risk

This book is about how to gamble and win.

Gambling lies at the heart of economic ideas and institutions, no matter how uncomfortable many people in the financial industry are with that idea. Not surprisingly, the game most like the financial markets—poker—is hugely popular with financial professionals. Poker has valuable lessons for winning in the markets, and markets have equally valuable lessons for winning at poker.

This book will give you insight into both kinds of gambling. We'll begin with basic information about poker and finance, then delve into the psychology of finance and the economics of poker. We'll review elementary and advanced tactics for winning. Along the way, we'll see how America's passion for gambling at poker and in the markets has shaped the country's economic success and national character, and spilled over to make the globalized world we live in today. I've stuck bits of my autobiography in the Flashback sections to make the points personal. Finally, we'll look at some of the cutting-edge work being done in these fields and some of the dangerous nonsense to avoid.

RISK

My first point is obvious but often overlooked. In order to win, you must take risk. Therefore, to someone who wants to win, risk is

good. However, I have great respect for risk. It is real. Trying to make a living at poker or trading, or anything else that involves risk, means you might fail. You might end up broke or friendless and miserable or dead. Or worse. If you don't really believe that, if you think that God or the universe or a Hollywood scriptwriter guarantees a happy ending for a shrewd, good-hearted adventurer—or that nothing really bad ever happens to people like you—this book will do you more harm than good. Of course, since God's looking out for you, you don't have to worry about that.

It's easy to say that there's no alternative to gambling, that you take risk by getting out of bed in the morning or crossing a street. That's true enough, but you *can* try to avoid unnecessary risk. More important, you can avoid uncalculated risks; you can always look before you leap. It's hard to win much that way, though. Other people snap up the riskless profits pretty fast and bid the price of calculable risk opportunities to near their fair values. Things get a lot less crowded if you go for the incalculable risks, leaps of faith that cannot be inspected carefully before takeoff. So that is where you find extraordinary opportunities.

If you can tolerate what life offers in low- and calculable-risk opportunities, you should take it. That is the defining strategy of the middle class, but it can be adopted by anyone, rich or poor. Choose a career in a low-risk field, and get plenty of good training. Be nice to everyone. Select sound investments; make conventional choices; pay your taxes; obey the law. Do a little better every year than the year before, and raise children who will do a little better than you. For many people, this is the American Dream. For others, it's the only sensible choice, the only kind of life that allows happiness without achieving it at the expense of someone else.

This book is for the rest of us, the ones who cannot imagine living that way. For some of us, conformity is the problem. We are sexual, political, or religious deviants, or uncategorizable eccentrics who just cannot fit into polite society. For others, born in war zones or under horrific governments, or abused as a result of caste or genetic aberration or other prejudice, the rewards of the limited safe choices on offer are too meager to merit consideration. Still others

among us are just bored: Conventional comfort is too dull. But the most common reason for embracing risk among people I know is pure egotism. We believe we have some talent that must be nurtured and allowed to flower. We must write or act or research or explore or teach or create art or just be ourselves as an end in itself. This obsession puts us above the rules and justifies any risk or action. I've never met a successful poker player or trader who didn't believe he or she was better than everyone else. Some make it obvious, but for most it is a quiet article of unexamined faith. If you have it, it's impossible to settle for what everyone else gets, however comfortable that is in absolute terms.

To me, that's the real American Dream. For most of history, there wasn't a big middle class. There were rich and poor, life was risky for both, and everyone gambled. The growth of the middle class began in seventeenth-century Holland. Europeans who achieved middle-class security generally stopped gambling and soon afterward tried to get everyone else to stop. But in the United States, the middle class grew so large by the nineteenth century that a sizeable population began to try to escape it. Europeans were shocked to see the western frontier populated not only by drifters and refugees, but also by prosperous eastern farmers who wanted more land, who risked ruin and death for the chance to get rich. Other successful people moved west to escape conformity—social, religious, or otherwise. Traditionally in world history, mines were worked by slaves or oppressed peasants. In the United States, college graduates, clerks, and men with property flocked to mining camps all over North America (to dig and play poker). Even more surprising, these same kinds of people often volunteered to serve as foot soldiers in wars (to fight and play poker). All of them threw away middle-class security to bet their lives and fortunes for wealth or freedom, and many of them found both. This unprecedented combination of opportunity and anarchy produced both poker and modern finance.

That some risks cannot be calculated does not justify ignoring careful strategies or acting on blind hunches. In the last 15 years, the field of risk management in finance has developed sophisticated mathematics to transmute chaotic profits of traders into valuable

revenue streams. For the first time, there is a legitimate science of uncalculated risk. The key is not minimizing risk, but managing it. A trading desk with good risk management can take on risks that would blow up an unmanaged desk. The same techniques can be used in poker and other risky endeavors. Poker players who understand risk management principles can play more aggressively in larger-stakes games with smaller bankrolls and have a better chance of succeeding.

RISK RULES

Here are four rules for taking incalculable risks. They apply to poker and trading, to getting married, to hitchhiking to New York to become an actress, and to devoting your life to developing a new theory of physics that everyone thinks is crazy.

1. *Do your homework.* Think like a middle-class person. Is there a safe way to get the same result? Can any of the risks be calculated? You don't stop figuring just because there's one aspect about which there is no useful information. Can you learn anything from people who have tried this before? Caution follows from my respect for risk. You must avoid unnecessary risks and, just as important, avoid taking risks blindly when they can be calculated. In traders' terms, you must take risk only when you're getting paid enough for it. In poker terms, you must extract all the value you can as a cardplayer before you start relying on your poker skills.
2. *Strike for success.* As Dickson Watts wrote in his nineteenth-century classic *Speculation as a Fine Art*, risk taking requires "Prudence and Courage; Prudence in contemplation, Courage in execution." If you do decide to act, act quickly and decisively. Go for maximum success, not minimum risk. Remember Macbeth's resolution after he decides to attack Macduff's castle: "From this moment, the very firstlings of my heart shall be the firstlings of my hand." If you want to learn to ride a bicycle, you have to get on and pedal. You might crash, but you might learn