WATCH AND LEARN

by Joel Kurtzman

Not long ago, I attended a breakfast in New York whose guest speaker was George Soros, the legendary hedge fund manager, philanthropist and social activist.

The point of the breakfast was for Soros to discuss how deep and how long the recession would be, and to explain how he had been navigating his way through it.

Not without humor, Soros started off by saying that he had predicted the Great Recession of 2007 to 2009 and that he had done so more than once. He also said that when he saw it coming, in 2006, he decided to come out of retirement to take the helm of his fund and to actively manage his investors' money and his own. How did he do?

He finished the recession $4 billion or $5 billion ahead — he didn't remember which — much of it for his own account. But what was really interesting about the breakfast was the way he explained his approach to investing and the reason he knew in advance that trouble was brewing.

Soros's analysis of the global economy was not based on numbers, he said. In fact, he explained that he was never very good at math and that his inability to do figures nearly cost him his degree at the London School of Economics. Instead, his approach was philosophical and observational.

Soros said he began to worry about the economy when the assumptions that people were making about the way economics worked began to seem wrong to him. For example, Soros said, people began believing that housing prices would only go up, that the stock market was the best place to invest *under all conditions*, and that the markets always worked and corrected themselves — a fact people said was somehow proved by the collapse of the Soviet Union.

These assumptions seemed correct at that time, and people eagerly assumed they would be true forever.

The problem was, according to Soros, that when these assumptions began to diverge from reality, people chose the assumptions over what was true. They began to issue mortgages with easier terms and little or no documentation requirements, as housing prices were topping out and credit scores were deteriorating.

Investors from around the world increased their holdings of exotic financial instruments, even as the risks of these products were increasing. People talked about the American export surge, failing to notice that it was based on a dollar that had lost half its value. Soros gave a number of examples in which perception, not reality, held sway.

Soros called this phenomenon *reflexivity*. This means when people's assumptions diverge from real events, they act as if their assumptions, not reality, are correct. This insight has given Soros a personal net worth in excess of $13 billion.

But even more interesting than what Soros said about reflexivity was what was going on in the room as the master talked philosophy. People began filing out.

As soon as Soros stopped talking about financial flows and the relative value of the dollar, and began talking about how people perceive the world and act on their assumptions, faces went blank. They did so even though these were the very tools that Soros used to make his money.

All of the people invited to the breakfast had earned the right to be there, either because they managed lots of money or had invested a great deal of their own. And yet, it seemed from the group's reaction that Soros's philosophy was playing out in front of his eyes.

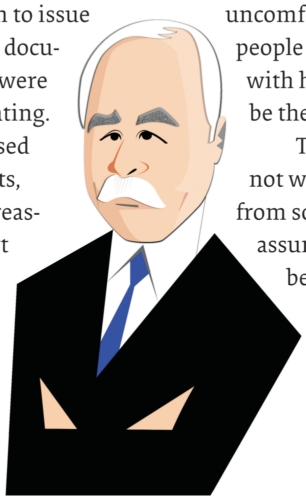
People heard Soros's views, noticed that they didn't match their own and dismissed them, even though they worked. They favored their perceptions, while dismissing those of a master.

There are many areas in business and in life where perceptions trump reality. They do so because of our need for familiarity, a reluctance to change, rigid thinking, and a host of reasons known only to Soros and a favored few.

But as we move into the new decade, we should be mindful that understanding the difference between perception and reality could give each of us a payoff, in our own realms, as big as the ones they have given Soros.

Accepting reality over what we believe to be true may be uncomfortable, judging from the looks on the faces of the people departing early from that New York breakfast. But with high levels of uncertainty and risk all around, it may be the tool we need to navigate our way ahead.

The decade just concluded has been a painful one. Let's not waste the experiences of that era. We could all benefit from some of Soros's determination to question transitory assumptions. Our job now is to watch and learn. It would be a shame to walk out of the room no wiser.



Robert Risko