THE

FAT

TAIL

The Power of Political Knowledge
in an Uncertain World

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UNIVERSITY PRESS
August 15, 1998, was a rough day for bankers. Leading economists were reassuring the leaders of Western financial institutions that Russia had both the ability and willingness to make payments on bonds held by international investors. With the 1997 Asian financial crisis still fresh in their minds, investors needed the reassurance, especially since Russian stock, bond, and currency markets had weakened substantially in recent days. Still, the advice of these economists seemed to make sense, and nobody panicked. Two days later, the Russian government devalued the ruble and defaulted on its debt. The fallout for investors was immediate and dramatic.

How did the experts get it so wrong? They missed a number of important political factors: Russia’s weak and unfocused leadership, the pervasiveness of its corruption, poor market regulation, and the fact that a handful of well-placed Russian officials would actually benefit personally from a devaluation. In sovereign credit models used by banks, all these factors were absent or stuck in the “error term.” They were considered too difficult to measure or to manage. But they were vitally important.

What do we mean by a “fat tail?” Fat tails are the unexpectedly thick “tails”—or bulges—that we find on the tail ends of distribution curves that measure risks
and their impact. They represent the risk that a particular event will occur that appears so catastrophically damaging, unlikely to happen, and difficult to predict, that many of us choose to simply ignore it. Until it happens. Russia’s 1998 financial meltdown represents a quintessential fat tail, one much worse than anyone’s risk model considered possible at the time. We generally expect that dramatic, high-impact events occur only rarely, appearing as “thin tails” on a curve. Yet, history shows that they happen with surprising frequency.

Russia’s financial crisis offers one of many cases in which a better understanding of a fat tail would have made a big difference for both investors and policy makers. The world of politics is dynamic and complex. It is not incomprehensible. Political risk can be understood and managed with much more success than most of us think.

Investors and corporate decision makers tend to approach the political risks they face in unfamiliar markets in one of three ways. There is the “We are all doomed” approach. We’ll simply ignore the risks, because they’re too scary and too complex, and what can we do about them anyway? There is the “Let the big guys lead” philosophy. We’ll ride along in the wake of the companies that have more resources and are better equipped to deal with the risks. If the big boys are safe there, so are we. Finally, there is the “We have our expert” strategy. We’ve already got a guy in-house who lived in that country for more than a year. His wife went to school there. He used to vacation there. He seems like he knows what’s going on.

None of these strategies are effective. To succeed in the current global environment, decision makers must acknowledge the limitations—and serious pitfalls—of these approaches. Management of political risk requires a dynamic worldview that includes a combination of flexibility, creativity, and demonstrated expert knowledge.

There is no single formula for understanding and managing political risk. In Brazil, monitoring and evaluating the behavior of political parties and politicians in the National Congress are crucial for the accurate forecast of policy outcomes. In China, analysis of the personal power dynamics within an opaque Communist Party and among elite factions is vitally important. But the tools most helpful in evaluating political risk in Brazil or China are almost useless in Saudi Arabia, where politics are a family matter.

A growing number of investors and policy makers understand the importance of political risk. Yet, they also know that they lack a comprehensive and sys-
tematic set of tools for evaluating these risks. Most corporations actively manage enterprise risks that directly affect business organizations, such as credit, market, and operational risks. Credit risk, for example, has become an enormous industry—in 2008, banks will likely spend $8 billion on credit risk software alone.2

Yet, most businesses spend far less energy on the assessment and management of political risk. A recent survey of executives on risk management in the financial services industry3 revealed that political risk was considered the least likely of all risk categories to be managed well. Geopolitical risk was also perceived as least likely to impact a corporation—and thus least likely to be included in a company’s risk management planning. Business decision makers, investors, and risk managers tend to ignore political risk until it produces a crisis—like the one that roiled Russian markets in 1998.4

Why do intelligent policy makers and corporate decision makers so often ignore these types of risk? First, they view political risk as too complex and too difficult to forecast. Perhaps some changes are simply not foreseeable. Second, risk managers like data, and they haven’t yet found much hard data on political risk. Many of the risk analysts working in the private sector have backgrounds in economics or finance. “How do we quantify political instability?” they ask. When it comes to data-driven forecasts, politics is too difficult to deal with. Third, companies often manage risks, such as credit or market risks, because the law says they have to. But there are no regulatory or legal requirements that corporations and financial institutions must manage political risk.

Yet, the dramatic increases in global economic integration, trade, and capital mobility in recent decades, combined with growing political instability and government intervention in markets, have created a climate in which political risk is more relevant than ever for companies and governments. This book will illustrate how political risks can be identified, analyzed, and mitigated—just like any other risks.

Political risk matters both at the macro (national and transnational) level and at the micro (local, regional) level. Geopolitical strategies drawn up in Moscow, Beijing, Tehran, and Washington will shape and reshape the international investment environment over the coming decades. So will efforts to enact market-friendly pension reforms in Ankara and Budapest that influence market sentiment on currency, bond, and equity prices. So will decisions made by local politicians and interest groups in the provinces, towns, and villages of the Brazilian and Indian countrysides.
In addition, investors’ time horizons vary substantially. In the near term, currency strategists and bond and equity traders manage the impact of today’s political developments on their market positions. Over the intermediate term, more strategic capital market participants take “long” views on country risk dynamics. Company managers cope with underlying local political and social stability. In the long term, corporations with substantial fixed capital assets on the ground and strategic planners for companies and governments must plan for a broad range of future scenarios.

Politics matter even in “safe” places. In the most politically stable markets like the United States, the European Union, or Japan, regulatory issues, often driven by politics, can have a dramatic impact on the business environment. The global banking crisis of 2008 exposed a number of serious flaws in companies’ risk management systems and highlighted the importance of effective regulation. Governments in the United States and Europe intervened with massive infusions of capital and vowed to dramatically overhaul the regulatory frameworks governing the financial system. In addition, consider the growing anxiety in the United States over foreign investment in politically sensitive U.S. assets. The Committee on Foreign Investments in the United States (CFIUS) has become a political football following the controversies over the aborted bid by a Chinese oil company (CNOOC) to acquire the assets of U.S. oil firm Unocal and the failed attempt by a state-owned Arab firm (Dubai Ports World) to operate several major U.S. ports. Concern is growing among EU member states that have faced off with the European Commission over energy policy and financial market deregulation. Germany recently passed a law to regulate investments by sovereign wealth funds (SWFs) in “strategic” domestic companies. External financial and corporate interests have been unhappy with Tokyo over regulatory constraints that both suppress merger and acquisition activity and favor domestic firms. Taken together, these regulatory changes in developed world governments intensify concerns among international investors that “backdoor” protectionism is on the rise.

Risk and Political Risk

Risk is the probability that any event will turn into a measurable loss. It is composed of two factors, probability and impact. How likely is the risk to occur? If it does occur, how big an impact will it have? Yet, in some cases it can be extremely difficult to answer either of those questions—or to determine what has created a particular risk.
A relatively straightforward risk comes with smoking. For Canadian men who smoke, the lifetime probability of developing lung cancer is 17.2%. For male nonsmokers, it’s just 1.3%. Data from medical research and life insurance companies allow us to establish a clear connection between smoking and cancer—and to accurately predict the consequences of smoking. Male nonsmokers in Canada have a life expectancy of 80.5 years. Male smokers can expect to live to about 73.7

Any “risk event” is part of a causal chain. A certain cause (or causes) can increase the chances that a specific event will occur. Once it does—whether it’s a market crash, a terrorist attack, or a change in government—it will have consequences. The consequences of an event depend on who is exposed to it.

Political risk is the probability that a particular political action will produce changes in economic outcomes. It is quite different from the risk of disasters, like earthquakes, disease outbreaks, and droughts. It is also distinct from economic risks, such as inflation or sovereign credit risk. Most political risks are much harder to quantify than the risk of smoking. Yet, on a fundamental level, political risk is no different than any other form of risk.

The Complexity of Political Risk

Often, it is not easy to deconstruct political risk in terms of its causes, probability, and impact. That does not mean that the process of analyzing difficult issues is not valuable. Take the Bolshevik Revolution of 1917.8 In October, after months of confusion and competition for political power following the abdication of the czar, Vladimir Lenin and other leading Bolsheviks overthrew Russia’s Provisional Government. They set in motion a series of momentous changes that would eventually lead to the establishment of the world’s first Communist regime. As the Bolsheviks transformed Russia into the Soviet Union, their new government nationalized private property, seized assets, ignored demands from foreign governments for repayment of debt, and forged new international alliances. The political, social, economic, and foreign policy profile of one of the world’s great powers changed quickly and dramatically. Could the risk of upheaval been mitigated—or at least recognized in advance?

Nearly a century later, historians still argue over how and why the Bolshevik Revolution took place. Some emphasize the economic crisis generated by Russian participation in World War I. Others place greater emphasis on the mobilization of peasants and workers already active before the war began. Other experts stress
the cruelty and incompetence of the ruling Romanovs. Still others point to eco-
nomic problems, like runaway inflation. Still others emphasize the emergence of
a coherent and ambitious Bolshevik leadership.

A risk event has complex and interrelated causes, and there is simply
not enough available historical data to definitively determine the probability
that the rarest of them will come to pass. Bolshevik Revolutions don’t come
along very often. Yet, if we had monitored political developments in Russia
in January 1917, we would have recognized that the situation was unstable—
and getting structurally worse. That assessment would have helped policy
makers and investors better prepare themselves for the upheaval soon to be
unleashed by an unstable Russia. How that can be done is the subject of
this book.

Interdependencies with Other Risks

For our purposes, it is useful to separate political risk from economic, financial,
and other types of risk. But in reality, one form of risk can easily generate another.
Gamal Abdel Nasser’s rise to power in Egypt in 1952 (a political event) led to
the expropriation of the Suez Canal in 1956 (a political and economic event),
which had a direct financial impact on those who owned shares in it. The politi-
cally motivated seizure of farmland by the Mugabe government in Zimbabwe
(2000–05) has led to, among other things, hyperinflation (an economic risk) and
famine (a threat to social stability).

This problem is not a new one. We can look back to the surprisingly
momentous consequences of a decision made in 1575 by King Philip II to default
on Spain’s debt.\(^9\) A series of economic and political risks produced a politically
motivated credit default, the independence of the Netherlands, and the decline
of Spanish imperial power.

Philip II inherited one of the world’s superpowers, giving him effective polit-
cal control of Spain, southern Italy, the Netherlands, Flanders (part of today’s
Belgium), and parts of France. Added to these possessions was Spain’s extensive
colonial empire in the Americas. Philip’s army and navy were probably the best
in the world. Soon, he would send the Spanish Armada to invade England (and
almost succeed).
So much power must have seemed a good thing, but the burdens that come with it had driven his father into a monastery. In 1575, Philip found himself fighting a series of seemingly intractable wars. His navy had been battling the Ottoman Empire in the Mediterranean for more than a decade and his army had struggled with Dutch separatist rebels for four years.

These wars were expensive, and Philip was running out of money. Most of his income came from the revenues collected from those widespread territorial possessions. Unfortunately, taxes had to be approved by local parliaments (or estates). Almost all the provinces had one, making it more complicated to simply raise taxes. After many years of war, these parliaments were increasingly upset by new requests for cash. Philip II had to borrow the money. Spain happened to be closely allied with the city-state of Genoa, the Wall Street (or the City) of the time. The Genoese gladly lent Philip money, as long as he paid the interest. But after years of borrowing, it became harder and harder to make those payments. Philip faced the difficult choice of asking his estates for new taxes or renegotiating the loans with the Genoese.

For Philip II, both options proved problematic. He first tried to increase taxes, but the Spanish estates said no. His Genoese creditors then refused to renegotiate the interest rates on his loans. With no better option, Philip decided to default in September 1575.10

The impact of this political act was swift and drastic. Genoese bankers refused to extend further credit to the Spanish crown. Without funds, Spain could no longer pay the large mercenary army fighting the rebel Dutch provinces on its behalf. By July 1576, the Spanish army in the Netherlands, which had not been paid in months, mutinied and began to attack Spanish-held towns. This unrest eventually provoked the sack of Antwerp (one of the great industrial centers of Europe) and the massacre of as many as 18,000 citizens. The Spanish reputation in the Netherlands and Europe collapsed almost overnight, as did any chance that Spain might quell the Dutch rebellion.11

Philip’s quandary reveals how one type of risk produces and fuels another. Spain’s political risks from wars with the Dutch and the Turks, combined with economic imbalances, significantly increased the risk of a sovereign credit default. The default then generated a new series of political and economic risks and imbalances.
**Political Risk and the Past**

What do the Bolshevik Revolution and a 16th-century Spanish debt default have to do with the political risks facing today’s policy maker and investor? Though political risks have become increasingly complex, the forces driving a politically motivated 16th-century credit default or a 20th-century revolution are not fundamentally different than those that create similar risks today. An especially important constant: political interests often trump economic ones in the performance of markets. In many cases, as in Russia in 1998, economists have argued that a certain event, like a default, will not happen because it would so badly damage that state’s economy. Yet, the politicians who will decide whether to default may very well make their decision with political, rather than economic, goals in mind.

Consider the problem of expropriation, the classic political risk faced by companies directly investing abroad. Mexico’s 1938 decision to nationalize its hydrocarbons sector provides a landmark example of how political motives can shape economic actions. It has also served as a kind of “best practice” model for the nationalization of natural resources in Venezuela, Bolivia, Russia, Kazakhstan, and Algeria. Iraq may well be next.

In March 1938, Mexican president Lázaro Cárdenas signed an order expropriating Mexico’s petroleum industry, which until then had been dominated by foreign companies such as Standard Oil of New Jersey, Gulf Oil, and Royal Dutch Shell. The decision yielded estimated losses of $200 million for U.S. companies and similar losses for the Anglo-Dutch investors. It also illustrates several factors that have traditionally led governments to seize private property and foreign direct investments: ideology, nationalism, domestic interest groups, national economic development, and geopolitics.

The nationalization of the oil industry formed one important element of a wider series of reforms under the slogan “Mexico for Mexicans.” Cárdenas sought to consolidate his power among core supporters from the labor movement and the political Left. The nationalization fit with a developing anticapitalist and nationalist agenda, and rewarded key domestic political constituents. The biggest winner was the petroleum workers union, which gained access to a steady stream of revenues and side benefits. The statist-minded Cárdenas also saw the foreign oil companies as an obstacle to Mexico’s economic development. As with future oil industry nationalizers in other countries, Cárdenas believed that his
administration, not foreign companies, could best manage Mexico’s economy and natural resources.

A final, and perhaps defining, factor was the geopolitical environment of the time. In the 1930s, the United States had begun to shift its approach to Latin America from “gunboat diplomacy” toward a “good neighbor” policy. With a political crisis looming in Europe (which led to World War II), the likelihood of an American or European backlash against Mexico had significantly diminished.

The nationalization was a resounding political success, and Cárdenas is revered in Mexico to this day. It also helped the ruling Institutional Revolutionary Party (PRI) maintain its grip on power by providing bases for patronage and by burnishing its nationalist credentials. But in economic terms, the expropriations and the creation of a national oil company (PEMEX) were a disaster. They provoked the flight of foreign know-how and capital; by 1940, foreign investment in Mexico had plummeted to a quarter of the level that the country had attracted two decades earlier.13 The loss of foreign expertise made oil exploration much more difficult. Revenues declined, and national debt increased.14

Mexico’s 1938 oil expropriation continues to impact the political risk landscape in Latin America, where President Hugo Chávez’s agenda in Venezuela borrows heavily from the logic of Cárdenas’s decision. Seven decades later, Mexico has a pressing need to reform the energy sector and to upgrade declining fields with the help of outside investors. Venezuela will face precisely the same problems in coming years, as foreign oil firms are driven from the country and as oil profits diverted for politically inspired spending projects push state-owned energy company PDVSA’s production into sharper decline.

Understanding Political Risk

What is the best way to analyze political risk? Given the complexity of its causes, its many potential impacts, and the diversity of forms it takes, there is no easy answer. Any political event that can (directly or indirectly) alter the value of an economic asset can be considered a political risk. A declaration of war, an act of terror, a law that expropriates private property, and a change in the rules governing foreign investment are all examples of political risk. Governments, rebel groups, nongovernmental organizations, individuals, and anyone else who engages in a political action can create political risk.15 The impact of a particular
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risk depends on who must absorb its worst effects. Corporations can lose people, money, or infrastructure as a result of political events. Governments can lose all of those things, as well as their independence.

There are a wealth of tools, methods, and ideas that can help corporations and policy makers better understand and forecast political risk. Effective management of political risk requires three skill sets: an understanding of which tools and methods are best suited to a particular political environment, awareness of how a particular analyst’s style and temperament may produce a particular kind of bias, and an ability to transcend preexisting assumptions about what is possible to successfully communicate a forecast.16

Style and Temperament

The disposition of those who assess risk helps determine how accurate or biased the analysis and understanding of political risks will be. Philip Tetlock argues that analysts can be divided into two types: “hedgehogs” and “foxes.”17 The hedgehog knows one big thing—and may display a near-fanatical adherence to it—while refusing to consider alternatives. The fox knows many things—and can draw on a wide array of data and analytical frameworks in making forecasts. Tetlock argues that foxes, who tend to be more tolerant of counterarguments and see the bigger picture, make better risk analysts. But risk analysis is contextual. In some cases, the simplicity of hedgehog analysis yields better results; in others, the complexity of fox analysis produces a more accurate forecast. When it comes to communicating the analysis, the hedgehog approach is sometimes better suited for reaching decision makers and cutting through existing cultural and organizational biases.

Foxes tend to be less successful than hedgehogs with scenario analysis. They can imagine many competing scenarios and too often exaggerate the probability of each of them. Hedgehogs believe in simple explanations, often consistent with a broader set of ideological beliefs, and can be overly confident forecasters. Equally important, they can remain unwilling to reconsider the merits of rival hypotheses after they have made a forecasting error.

The best forecasters whom Tetlock studied have two characteristics. They are eclectic thinkers who are tolerant of counterarguments. They also avoid
the common mistake of overestimating the probability of change. The approach to political risk we will set forward in this book reflects this basic spirit. We are eclectic in our methodology rather than wedded to a single model of political risk or political change. And we are cautious about exaggerating the probability of fundamental change, whether for better or for worse.18

Making Risks Known

Another key component of understanding political risk is its successful communication. If a risk is not properly communicated, timely identification and accurate analysis are useless. Al Qaeda’s attacks on New York and Washington, DC, on September 11, 2001, killed nearly 3,000 people, the largest death toll produced by warfare or terrorism on American soil since the end of the Civil War. In hindsight, all the data needed to predict the attacks was there. So was much of the analysis. Al Qaeda–associated Islamic terrorists had in the 10 years prior to September 11 tried to crash planes into tall buildings (in Paris, for one) and had attacked the World Trade Center in 1993. The U.S. government’s domestic security agencies had at least in passing considered an airplane suicide plan scenario.19

Yet, miscommunication between security agencies, failure of imagination, and the constraints on risk managers who must process large amounts of often competing bits of information on many different sources of risk prevented any warning of imminent danger from being successfully transmitted to those in a position to thwart the attacks. Some things get lost in the information flow. Others are blocked by social and organizational biases.

One common type of bias is bureaucratic. Organizations develop idiosyncratic cultures and processes that produce specific worldviews. During the Cuban missile crisis, the Kennedy administration worked hard to avoid a “tunnel vision” scenario in which institutional assumptions about Soviet intentions and behavior might have ignited direct and unnecessary confrontation with Moscow.

Idées fixes and wishful thinking constitute another type of bias. When German forces invaded the Soviet Union in June 1941, Stalin’s initial reaction was to discount the reports. The invasion did not fit his expectation, and he rejected it. Could reporting of the risk have been successful, given Stalin’s personality and his reputation for punishing the bearers of bad news? Difficult personalities and biases of decision makers pose a challenge to effective risk management.
These are only two of the many biases that can block accurate and timely reporting of risk. Ultimately, our understanding of political risk is inherently tied to our cultural and ethical values. The potential events we consider most frightening are those that threaten the things we most want to protect, like our independence and the value of our assets and investments. Thus, perception of risk is as important as the risk itself. We don’t necessarily face more risks than our ancestors did. In many respects we are more secure. The plagues, famines, and political unrest faced by those who came before us (think Mongol invasions) now offer little more than entertainment (think “Conan the Barbarian”).

Generations past often blamed gods or fate for unforeseen and unhappy events. Modern societies understand risk differently. Our risks may have not increased, but economic globalization and the sophistication of our technology have expanded both the complexity and the interdependence of the challenges we face, including nuclear proliferation, terrorism, state failure, and the more rapid pace of political and social change. As the stakes for global stability have risen, the need to better understand and more successfully manage political risk has become more urgent.

**Book Overview/Roadmap**

In this book we discuss a broad range of political risk types, ranging from global risks, which play out in the international system, to country risks, which manifest themselves in a specific society or government, to micro-level risks, which occur at the substate and industry level.

But we will start by acknowledging how much we cannot know. To understand political risks, it is essential to accept that much is beyond our ability to forecast. Many have argued that the interaction between the enormous variety of actors making policy decisions—individuals, groups, and states—and human psychology, history, and economics, as well as the natural environment, has created a world that is largely driven by unexpected, undeterminable, and frequently catastrophic events. It is worth exploring first the things that are unpredictable and uncertain—and there are many. The next chapter will focus on this theme.

However, much can be predicted, and there is a significant amount that corporations and governments can do to understand and mitigate the negative potential of political risk. The following six chapters will focus on broad types of
political risk, the geopolitical (those resulting from international wars or great power politics), expropriation, regulatory changes, or social unrest (a broad category that can include anything from civil wars and revolutions to mass demonstrations). Each chapter will detail how each risk is identified, weighed, and mitigated and explain how companies and governments did and didn’t assess the risk effectively.

Understanding risks is only half the game. They must also be effectively communicated. In chapters nine and ten, we consider the challenges of ensuring that risks are understood by the right people at the right time. The final step in the process—mitigation. Even if you correctly identify a risk it is not always obvious what a firm or government should do about it.

We are not at the mercy of fat tails. Now we turn to why that is.
The Fat Tail: The Power of Political Knowledge for Strategic Investing (Oxford University Press: 2009) is a book by political scientists Ian Bremmer and Preston Keat. Bremmer and Keat are President and Research Director, respectively, of Eurasia Group, a global political risk consultancy. In The Fat Tail, Bremmer and Keat discuss a broad range of political risks, including geopolitical, country, and micro-level risks. They explain these political risks, and lay out how to effectively recognize The fattest tail distribution has just one very large extreme deviation, rather than many departures form the norm. How does quantitative finance deal with fat tails? The traditional statisticians approach to fat tails has been to assume a different distribution but keep doing business as usual, using same metrics, tests, and statements of significance. They fall into logical inconsistencies. Once we leave the zone for which statistical techniques were designed, things no longer work as planned. The Fat Tail. 79 likes. I am fascinated about things that happen more often than people think they do. In this page, I try to review books and concepts... Facebook is showing information to help you better understand the purpose of a Page. See actions taken by the people who manage and post content. Page created 12 May 2018.