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Investing in Companies Driven by Accruals

Since I work with life insurance companies in my business, I don't invest in them. This constraint is quite easy to follow since I don't have a clue how to determine how much a specific insurer is worth. Two basic rules of investing could be compromised: knowledge and ethics.

Primary items on life insurers' balance sheets are not widgets or buildings, but promises. To calculate a value, these promises are converted into quantitative models. Assumptions of future contingent events and discount rates are used to generate a present value of future cash flows. For life insurance and fixed rate annuities these assumptions are relatively fixed. You can compare the regulatory value of similar blocks of business between companies even if you don't agree with the assumptions deemed appropriate (often the case). Interest rate generators, for example, are built using historical US data going back 80 years, ignoring extreme experiences in countries such as Japan, Russia, and Brazil. For equity based products there is more freedom, but even the stochastic assumptions have not historically held up. Stock returns have fatter tails than most models assume.

Securitized assets fit the same profile. When a group of junk bonds are rolled together to form a CDO or home mortgages are combined to form a residential mortgage backed security, the assumptions about the individual assets and the correlations between them drive the value. This value is very sensitive to the assumptions. There is little transparency in these assumptions to the buyer, and results are very sensitive to the assumptions chosen. This makes the investor dependent on these models and those who have insider access such as rating agencies. Model risk is large. Investors should include a margin of safety for this lack of knowledge. Those who relied on assumptions built from credit risk and applied them to comparably rated RMBS assets have learned this the hard way. Those who used leverage to make strong reported earnings out of weak actual earnings are also finding that the markets do not always stay in the normally shaped portion of their distribution.

Investor Expenses

At each year end I sit back and review my own personal investing experience. Except for 401(k) balances that do not allow me to do more than choose between mutual funds, I no longer own anything except individual stocks in our portfolios. Using a broker that charges less than \$10 per trade, our investment expenses were less than 1 basis point in 2007. Why is no one writing about this great discrepancy? If an individual can invest with expenses at low single digit levels, why do we highlight an index fund's "low" 10 bp charges? Of course this is because we live in an environment where 100 bp charges are among the better results. Hedge funds, with their charges of 2% up front plus 20% of any positive results, are beyond belief. Few earn enough to justify these types of payments, and it is difficult to tell in advance. It especially disturbs me when a hedge fund uses high leverage to take miniscule excess returns and then borrows to ratio them

up. They claim this is alpha and reflects their skill. They have decreased the probability that the investor will not receive their money back, but that is rarely discussed until the “perfect storm” hits. This seems to occur in some market every couple of years. Calling excess returns alpha, due to skill, and paying for that skill makes sense to me if they are considering only unlevered returns. Otherwise their clients are unlikely to fund anyone’s yacht except the hedge fund manager.

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