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Investment Topics

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Stock Market 2008 versus 1999

The current stock market is much harder to value than it was during the tech bubble. At that time, you could look at high or nonsensical P/E ratios or compare earnings against cash flows and it was fairly obvious which companies were not good values with margins of safety. In 2008 it was much harder. The tide went out and many ships were beached, both those with phantom earnings and those with real assets making real goods. With earnings dropping so quickly, and debt to equity ratios increasing so quickly, that all holdings should be reviewed. I learned this the hard way a few years ago when a video store called Movie Gallery bought Blockbuster, taking on an enormous amount of debt that it never overcame. I sold while it still had some value, but treated it as an education I would not soon forget. Today I periodically check, because as equity values drop the debt/equity ratio increases.

Pension Plans

There are many actuaries who have worked on pension plans who feel that someone who has not done so has no reason to get involved with them now. I view the issue differently. When a fellow CFA charter holder receives bad publicity for some scheme, I am offended partly because they have lessened a credential that I worked hard to earn. I feel that some actuarial practitioners have lessened my primary credentials by hiding behind the laws that they had input writing. The best example I have of this is defined benefit pension plans. I struggled more on that exam than any other, mainly because the valuation methods introduced made little sense to me. (I must admit that many complex opportunities for products or investments have been presented to me, and I always felt kind of dumb because many did not make sense to me and I was the outlier. I feel better now, and more confident that I should share my thoughts through this newsletter.) I never understood why you could discount at a different rate than you projected. I thought I was just stupid. It turns out I was more right than I realized. Here are my requirements for the next generation of defined benefit plans. Keep in mind that I do listen to comments made about my ideas and often improve them iteratively, so perhaps I will circle back to this in a future newsletter as well with some improvements.

- Valuation of the benefit accrued in that year should be determined using a methodology that a third party would accept.
- Valuation should not be back ended. This will allow employees to take their DB plans with them.
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While pension plans have boards whose fiduciary duty is supposed to be to the members of the plan, this rarely happens. Generally senior managers who farm out their personal

investments do the same for their employees, knowing that they have an add-on plan that will cover the majority of their retirement needs. They define fiduciary duty as doing what will minimize the likelihood of lawsuit, not what is best for the employee. Fund choices are offloaded to a third party, whose fiduciary definition is the same, leading to dot-com funds in 1999 and other momentum strategies guaranteed to underperform over time.

Buy and Hold Strategy

While buy and hold will work in many environments, an investor should keep in tune with changes in events that are applicable for a specific firm. I had been a long time holder of Washington Mutual, believing their statements that they had hedged their interest rate risk. At the same time I watched for quotes from management (part of an environmental scanning process so important to both investing and risk management) that showed a change. Once I saw them, I sold. While I did not get out on top, the story had changed and I was no longer comfortable with their prospects so I sold. Buy and hold differs from buy and forget.

AIG Update

Based on how much my taxes will go up because of the AIG loans, I should have offered to pay to review their ERM process. Between their aggressive use of economic capital, overreliance on models for products such as credit default swaps, and securities lending extremes, it seems like enough red flags would have been raised to perhaps forestall their problems.

Stolen Quote

The market is like a broken clock. Correct only occasionally.

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