

**October 2009**

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### **Concentration of Power Risk**

A risk that we never talk about has become the elephant in the room. Some would call this ego risk, but at most institutions decision making occurs primarily at only the highest levels. It has been a year since I wrote a financial essay titled *Does Your Company Need a Chief Skeptical Officer?* I don't think it has gotten any better. This is not due to poor goal setting. These senior officers believe they are doing what is best for their firm. Unfortunately, all of us tend to fall in love with our best ideas. We see that when we invest, where we hold losers far too long. When a manager has worked hard for a long period of time to develop an opportunity it can gain such momentum that it can't be stopped no matter how poor the idea or the timing for the idea is. Many companies continued to write loans that previously had been securitized while liquidity in this market dried up. Others threw good money after bad on commercial real estate properties while existing properties were sitting vacant. There are very few companies that have instilled this skepticism in their risk culture. Berkshire Hathaway is one, where both Warren Buffett and Charlie Munger are comfortable in their own views and are encouraged to say what they think to each other. It will be interesting to see if this culture extends to the next generation of leaders at this highly successful firm. One way to ensure this is to practice consistent pricing discipline. When an opportunity comes about, the same financial analysis should always occur. This will include setting risk appetite, hurdle rates, and capital. It will not include having the CEO override the discussion.

There is no momentum to create this type of culture. Perhaps it should be developed at the board level with independent ERM experts providing the process and bringing in specific topic experts to anonymously consider these risks.

### **Quick test to determine good ERM**

Here is a fool proof way to identify strong ERM. During a rating agency presentation, is ERM represented? Do they conflict with other presentations or, even better, discuss instances where they have had disagreements and how they worked through them. Getting a direct and honest answer to "What keeps you up at night?" especially if the CEO or Chairman are present will tell you where strong ERM occurs.

### **Board Voting**

A topic I am spending time trying to get my hands around is risk appetite. There are several articles out there, and they all assume that there is no concentration of power risk. This led me to think about the voting process when I receive a proxy for annual elections of directors. This is hard, because so many of these people have played the system over the years. Many have held public office and then serve on boards. Why this is not a conflict of interest I do not understand. In any case, it does not seem like board members

are placed in that role in order to make waves. Those who do are soon gone and lose their hefty stipends. What I am amazed to find, and always vote against, is board members who hold fewer shares of stock than I do. How are these people's interests aligned with mine?

## **Health Care Reform**

There is still no consensus on this very important topic. Democrats continue to let the trial lawyers keep tort reform out of the plan, and Republicans demonize the public option. Why don't they have us pay for health care through a tax on income (like FICA) and give all players the same rates negotiated by the government? This would provide mandatory coverage, remind us all that there is a cost, and provide a true level playing field. If the government gets a better deal, cost shifting will continue to occur until it spirals into a single payer system.

## **Influenza**

Here comes wave 2 to the northern hemisphere. So far it continues to act as a contagious but not virulent strain of H1N1, although there are signs that a version active in South America has gotten stronger. The mortality risk continues to be for those with secondary infections. This will cause chaos this fall, especially if it mutates and combines with H5. There are many interesting studies being done today about 1918. It's disappointing that they were not done several years ago.

## **Scenario Planning**

Institutions should have developed their stress scenarios for 2010-15 by now. Going forward I plan to compile my own scenarios that I think are possible over the next few years. They will be released publicly with my financial predictions in early January.

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