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Round Two of the Financial Crisis?

Will a falling Euro be the trigger that leads to a Chinese economic implosion? There are many signs that China is a bubble economy. Overbuilding, unsustainable environmental policies, and a fixed Yuan are all warning signs. How it will play out is uncertain but will materially impact the world economy.

I recently listened to *The Big Short* by Michael Lewis (one of my favorite authors) and am currently reading *The End of Wall Street* by Roger Lowenstein. Both take the view that the mispricing in the system is currently being corrected and the resulting system will become more transparent and ethical going forward. I disagree. Governments are still trying to save everyone who made mistakes in the past. The latest bailout would go to the union pension plans. State bailouts await. Without creative destruction capitalism does not survive.

Fortunately for individual investors there is a herd mentality on Wall Street. No one gets fired for losing when everyone else is losing, and this gives the little guy an advantage. Since most of us are dealing with relatively small amounts of money, we can "pick our spots" where we do our own analysis. It takes time, but the skill set that makes a good risk manager comes in handy!

Role of regulators in disasters.

The BP leak is similar to the financial crisis. Prior to the event that was no substantive regulation, and of course there was no ownership by Congress.

Timing of debt to avoid reporting.

A problem with balance sheet accounting is that it is easy to hide positions because reporting is intermittent. This is the same issue as point in time reporting of mutual fund positions. There is very limited transparency.

What you can't measure, you can't manage.

Is there a qualitative component to ERM? Of course there is. To say otherwise is short sighted and indefensible. It comes across the same as someone who believes their model is infallible and should be used to regulate without interpretation.

Assumptions for PBA

Principles Based Approaches to capital only work if the assumptions are credible and reflect the future. One assumption that drives results for some products is the lapse rate.

For universal life products, with flexible premium payments, it is thought that lapses vary by how well funded the product is. A fully funded policy with a large account value is more likely to stick around than one that is funded as a term policy and lapses as soon as one payment is missed. It has long been thought that a driver of these lapse rates is what is called the r ratio, which compares the actual fund value against a theoretical fund value that would fund the policy for its lifetime.

For such an important assumption, how often is it used in cash flow testing today? How credible is it? What splits by r ratio are useful? When I was responsible for cash flow testing results about 10 years ago my thoughts were that ratios below .25, .26-.75, and above .75 might be reasonable. Has anyone tested beyond these qualitative guesses? Have they published their results? What guidance is available? Are companies pricing these blocks of business using these differences? Are their marketing arms involved in this discussion? How the product is sold will drive the volume in each category here.

Without this type of analysis, and stress testing of these assumptions, any PBA results of these products will lack credibility.

Emerging Risks

I have been asked by Schwab to comment on various issues. Here is a response I gave when asked about emerging risks.

I worry a lot about emerging risks and have done several research projects related to them. I especially try to tune in to unintended consequences of events and potential events. An example would be the Icelandic volcano eruption that disrupted European air travel and caused influenza vaccines to be delayed to Australia. Another thing I worry about is risk combinations that could act in concert to make an event worse. A regional food shortage is a good example of that, with water issues and political instability interacting to create uncertainty. During the BP disaster I worry about a hurricane in the area. I am also worried about the impact of a pandemic in Haiti when the people there are vulnerable. A really good book is *The Next Catastrophe*, written by Charles Perrow. Even he missed the gulf oil risk when talking about the concentration risk present almost everywhere.

If there is a specific risk keeping me up at night I try to minimize exposure to it in my portfolio. Often I am too early to get out, but that's okay.

For key risk indicators I interpret media accounts and try to guess how the herd will react to them. This qualitative approach has worked pretty well to predict market highs and lows, although I generally don't trade based on them. I try to look for opportunities as well. This would be industries such as water infrastructure, trying to choose those companies that produce the picks and axes (who made money during the gold rush - not the miners) and buy them before they become popular buyout targets. Most of my capital gains are due to buyouts.

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