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Deja vu?

"Black Swan" is the new "Perfect Storm". Professional money managers know they will not be fired if they do not anticipate an event their peers do not see coming either, so they use these terms to convince the investing public that it is not their fault. There is job security in following the herd. There is room for discussion about how far out in the tail the manager should plan for, but disagree that these types of events can't be anticipated. Even if specific events are not looked at, setting up a flexible process that minimizes concentration risk in decision makers as well as other types of risk. It does not matter if you have a process if there is no one available to make a decision. Maybe we should define terms such as Black Swan 100 years, much as earthquakes are defined by how often they might be expected to occur. By setting expectations of one new Black Swan every 100 years this would at least avoid the current mess where Black Swans can be declared 4 days in a row.

Transparency

I would argue that much of what went wrong prior to the financial crisis was due to a lack of transparency. Risk tends to grow when it is in the dark, and shrinks when exposed to light. Yet I see little improvement based on recently enacted regulations. Fund companies report only once per quarter, and even then actual positions are only revealed months later. (Even reporting daily positions with a delay would be better than what we have now.) A fund company can trade into or out of a position on the last day of a reporting period and reverse the trade on the first day of the next. A money market can hold exposures to sovereign debt, either through direct investments or indirectly through credit default swaps or by investing in foreign banks, and no one knows. Banks were afraid to loan to one another in 2008 and 2009 (and even today) because they did not know their counterparty's exposures to other risks. Why don't any banks take the lead in improving this transparency dilemma? Legislators don't seem interested but it seems it would be a competitive advantage for the first firm to address these liquidity concerns.

In the meantime we wait for Dodd-Frank to be implemented. The further we get from the crisis before anything is enacted the more likely this legislation will be watered down. Consumer protections are more likely today to be accomplished through media coverage than anything Congress has done. Yet businesses are still overwhelmed by the amount of paperwork they are required to complete. In my business my highest expense is insurance in case I am sued. This is ridiculous. And I would have to take out even more insurance if I wanted to open an asset management business. A risk manager should not be limited in the projects they accept by threat of lawsuit. That does not align incentives. We make better decisions when we understand all of the risks accepted.

Savings Incentives

We profess to want people to save for their retirement, yet look at how the incentives have been set for savers. If you have saved some of your income you are currently facing some tough options; low interest rates and risky money market funds, or accepting a risk you don't understand as well as interest rate risk and investment grade bond credit risk. If you are part of a pension plan, the assets are accumulating at that low rate and future liability streams are discounted at that same low rate. This increases the plan underfunding gap. Life insurers are increasingly challenged to find high enough returns from interest rates to meet legally required guarantees. This will force them to take risks from other sources, much as they did in the past by looking for a few extra basis points from liquidity and credit risk. Now we will see insurers challenged by risk-adjusted returns from junk bonds, preferred stock, liquidity shortcomings and maybe even common stock. The NAIC should put this on their agenda before someone blows up. It's just a matter of time.

For individuals I find it odd the way my own portfolio is growing. If I have cash in both qualified and non-qualified accounts and a stock I wanted to buy, I put dividend paying stock in the qualified account and dividend-free stock in the NQ account. I am incented to keep as little income as possible in my NQ account for tax purposes. But when I disperse these assets in retirement, these turn into income so I am better off to have dividend paying stocks in my NQ account. So my incentive is to swap out my portfolios during my retirement years. Does anyone else think this is goofy? A solution would be to give corporations a deduction for dividends paid and tax dividends as income to recipients as I have suggested elsewhere. If public policy is to encourage savings, then it also needs to be sure we don't punish the saver who passed up the annual trips to Mexico to build their nest egg.

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