

November 2011

By Max J. Rudolph, FSA CFA CERA MAAA

Preparation

One of my pursuits away from the business world that I greatly enjoy is coaching youth baseball. Each year the game changes its focus as distances lengthen and bodies strengthen. I worry that my practices will ignore some important skill set the team has not previously seen but will see in their next game. It's easy to fall into a trap when a team is going well where you repeat the same practices over and over, focusing on repetitions and routine. This is when it is even more important to mix it up and challenge your players. This teaches them to be flexible when that eventual unknown hits. We learned this firsthand when we played in our final tournament of the season (11-year olds) and our centerfielder lost 3 balls in the sun. It was not his fault as we had focused on making sure we could catch easy fly balls and not on shielding their eyes. This can also be a tool that engages players to bring practice ideas to the coach. While this could easily be a lead-in to a general management white paper about involving your employees as part of a team, here I want to talk about preparing for emerging risks as a risk manager.

By definition, emerging risks are something you would not normally be talking about or preparing for. You have to prioritize your efforts, and time is in limited supply. Not everything needs to be quantified. This is an example where you can manage even when you aren't measuring a risk. Qualitative analysis is the only way to consider as many emerging risks as you can identify. For a first pass you might look at each emerging risk as a grid across lines of business. Have each manager respond to "Rate this risk from 1-10 for your line of business. The risk manager should consider interactions between lines and assess for the entity as a whole.

There are a wide range of emerging risks. I think that risk managers should have a core set of scenarios they use regularly with line managers, and merge in new ones regularly so the line managers don't have the option to take their old report and copy it without considering macroeconomic and environmental changes, among others.

Global Warming and Emerging Risks

Here is an example I used when I visited the University of Manitoba this fall to speak with their actuarial science students. I started the discussion by talking about global warming and asking if they had seen it change their lives in Winnipeg. I expected them to talk about the localized flooding they had experienced on their campus for much of 2011. But their fears rested more with the increasing threat of tornados, which they had not had to deal with in the past. Their concern was that similar weather phenomena would become more prevalent in Manitoba. Other changes for that particular part of the world can be considered opportunities. Longer crop seasons, greater range of crops (e.g., rotate soybeans and corn with wheat), better transportation leading to trade (northwest passage)

and greater access to resources as latitudes further north become accessible were also considered. How all this will interact with conditions in other countries with their own emerging risks would be a great dissertation project.

Correlation and Tail Risk

The new requirements to develop Own Risk Self Assessments (ORSA) allow companies to model diversification benefits. But in the tail of many distributions the correlation becomes greater than one. I wonder if any models will be considering this? Of course they won't. That would increase their capital requirement. The NAIC, or whatever regulatory body ends up in charge of this, should consider this modeling anomaly. Charlie Munger, the Vice-Chairman at Berkshire Hathaway, calls this the lollapalooza effect. When the stars align, sales take off. When they align in a different way, credit risk correlation moves to 1 and liquidity risk also kicks in. It could be good or bad. This is something I hope get considered during this process. This will probably be an ongoing newsletter topic for me as I think through this topic.

I hope you have enjoyed my newsletters for 2011 as much as I have enjoyed writing them. Best of luck to you during 2012!

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