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Concentration Risk – A Guaranteed Outlier

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I have been following markets for a long time. I can distinctly remember listening to my Detroit Tigers on the radio as they came from behind in games during their championship season of 1968, so I have been a sports fan even longer (and appropriately so). But I recall seeing the paper announcing the Penn Central bankruptcy in 1970 and noticing that, when Walter Cronkite reported the daily stock market (the Dow), it would advance to 1,000 and drop back repeatedly as if there was something blocking it from advancing higher. As we see now the market is not capped (the Dow Jones Industrial Average is currently higher than 13,000) and creative destruction, allowing companies to fail, is the key to sustainable growth. But there seems to be one exception. Banks. Wait – am I allowed to say that? ☺

Financial Crisis

The recent financial crisis created history and will be studied for years. Some have argued that this cycle started with the bailout of Continental Illinois in 1984, nearly 30 years ago. In *After the Fall: Saving Capitalism from Wall Street – and Washington*, Nicole Gelinas (senior fellow at the Manhattan Institute) argues that the supposedly free market advocates in the Reagan White House intervened to prevent a contagion and set a precedent of overriding credit risk in the markets. Once “Too Big to Fail” was recognized, the cost of debt continually came down for risky financial institutions at the same time laissez faire was taking hold and more risks were being added to balance sheets. An incentive plan where management gets the upside and taxpayers cover the downside, and management doesn’t even lose their jobs, is tough to compete with.

Regulators and rating agencies were treated as clairvoyant, and a “good” rating became necessary for many investors to buy a specific bond. Many have found the market’s spreads to provide more discipline than a ratings process. Of course that assumes the government itself has not altered the playing field for the participants. The Federal Reserve, following Paul Volcker under Alan Greenspan and Ben Bernanke, has attempted to “manage” the economy. Unfortunately their definition requires them to act when the market slows but to keep their hands in their pockets when bubbles are forming. On top of that, bubbles formed as a direct result of low borrowing costs encouraging high risk taking (and continues today).

Taking a Crisis for a Drive

Each time markets cycle new regulations are designed to keep the last crisis from redeveloping, but sometimes leave unintended consequences that lead to the next crisis.

Over the past several years I have developed a checklist of risks that have had a part in bankruptcies, using it when making personal investments and looking for risky enterprises to avoid. They are culture, accountability, incentives, exposures, leverage, and systemic risk. The overriding characteristic of each is concentrated risk. A belief that a firm knows more about a specific risk than others leads them to buy a lot of it when they spot an anomaly. If you think of a normal distribution with broad, diversified, risks then the resulting bell shape is fairly tight. It is rare to have an extreme outcome. This is why investors use asset allocation schemes, balancing their risks in total. But if you have only one risk, then the result cannot be diversified away. Sometimes the result is good, but occasionally it is so bad that the company ceases to exist.

Culture

A firm's risk culture goes well beyond ethics. As Warren Buffett said when brought in to save Salomon Brothers, you should assume that everything you do will be featured on the front page of your local newspaper for family and friends to read. This goes well beyond doing what is strictly legal, incorporating the problems associated with rules based accounting regimes. The ethical person follows principles, consistently offering everyone the same deals available to family and friends. Culture is driven both from the top of an organization, with the CEO leading, and the bottom, where culture is embedded.

Examples of cultural shortcomings include Enron, where a rules-based accounting system was used to hide off-balance sheet liabilities and mark-to-market accounting carried out the misdeeds of the senior leadership by accelerating nonexistent future profits.

Accountability

Accountability is integrated with several other issues but is a significant reason for the recent financial collapse. Any time a salesman sells a product and is compensated based on the sale and not the resulting profit, accountability has been lost. Mortgage brokers who sold home loans without documentation, even when they did not lie and fill out the application themselves, and then passed on the risk to others lacked accountability. But how is this different from the drug sales rep who sells a pill that does damage to a fetus or the grocer selling tainted lettuce? The broker is trained to know the difference. The drug rep and grocer were told the product was good and did their specific job in the supply chain.

Incentives

Too big to fail, where the government subsidizes credit risk, generates a poor incentive for adding value to shareholders. But what is the incentive for the risk manager? If paid with a bonus for meeting profit targets, isn't this a perverse result? Incentives need to align between sales managers and stakeholders or you end up with unintended consequences. Higher sales are not always a positive event for the entity as a whole.

Exposures

Most think of a large natural disaster when thinking about an entity's bankruptcy. This occurs if there is a concentrated exposure to one risk and lack of diversification. This is why the reinsurance industry is so important, as it is able to create geographic, asset class, and product diversification to create a stable cash flow. More will be said about them under systemic risk.

Leverage

Borrowing, also called gearing, appears in many bankruptcies where the firm seemed to have a reasonable chance of success but gets overextended. The investment strategy used by Long-Term Capital Management, looking for arbitrage opportunities and waiting for them to clear, would have earned very small but steady returns. Instead, the hedge fund earned very high returns for several years, then nearly blew up financial markets when it became highly levered and loans came due at an inopportune time.

Systemic risk

When everyone uses the same tool to mitigate risk, or invests the same way, or builds the same product, there is a risk. When you hear them say "It worked until it didn't", this is systemic risk. It does not require the entire financial system to collapse. In our reinsurance example, many of the world's reinsurers use each other to lay off risks or have investment claims, and many of the tools and databases are at least similar if not the same. I personally have a concern that if one reinsurer goes under there will be contagion and others will go with them. In 2008 banks realized there was little transparency in their financials and refused to loan to each other, let alone to businesses and individuals. Market liquidity dried up and correlations moved towards one.

The Biggest Concentration Risk is Ignored

Many of these risks are present in every company. Running stress tests and what if scenarios, especially qualitative discussions, will help a firm identify which risks are really important. Transparency and oversight, driven by skepticism and contrarian ideas, go a long way to reducing these risks.

So is there a risk that is the "elephant in the room?" I say yes. Concentrated decision making, when the CEO or a favored subordinate can do no wrong, has led more companies to bankruptcy than anything else. Every company needs a strong CRO who is encouraged to speak their mind and has the smarts to know when to do so.

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