

Newsletter

My name is Max Rudolph. I am a credentialed actuary and CFA charter holder working as a sole practitioner in Omaha, Nebraska, USA. I write a monthly newsletter, covering a variety of topics. It has varied from 1 to 4 pages, but most are less than 2 pages. Coverage is mostly related to risk management and investments. Some are written at a high level, dealing with the general economy, and some cover very specific topics. I try to write something about the current financial environment, and there have been plenty of topics so far. The newsletters are educational in nature and do not constitute investment advice. The newsletters are released publicly at www.rudolphfinancialconsulting.com after 3-6 months.

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Financial Predictions for 2008 – How Did I Do?

Please remember that these predictions are for fun. If I knew what was going to happen, I certainly would not share that information with others! You must make your own decisions regarding your financial future and not hold others, including me, responsible for your own results. Enjoy!

Most of these predictions were made in late December 2007, although final editing did not occur until late January 2008.

- **Economy:** there is not much positive to look forward to in the United States. The consumer has kept the economy afloat longer than I thought possible. The tide is likely to go out in 2008. How many consecutive years can the stock market show positive results? The economy might not formally hit a recession, but growth will continue below long-term averages. There are many issues to worry about: budget shortfalls, currency imbalances, credit issues, uncertain political situation, etc. A physical disaster could put the economy over the edge. I don't expect a depression, but every time the Federal government bails out a bubble "victim", the inevitable correction comes closer and will be deeper. The shots to the economy administered by the Fed late in 2007 should start to take effect in 3rd/4th quarter 2008, just prior to the election. A new President will likely reduce military spending and work toward a balanced budget for the first two years of their administration.

- Results: I got this one, for the most part, right on. The world economy fell much deeper than I expected due to the liquidity crisis, so although the US economy only recently officially was reported in a recession the monetary stimulus has merely slowed the fall. A short term balanced budget is no longer in the cards.
- Comment: Luckily, at least in the US, there have been minimal material physical catastrophes. Low interest rates are back, but the lack of liquidity in the system will make it harder for excesses to take hold. There are still unintended consequences yet to come.
- Volatility will stay above long-term averages, although I don't expect it to surge above 30 unless there is an international crisis. VIX is currently at 22.50.
 - Results: Partially right. The VIX hit a high of nearly 90 and was consistently very high. It was never low. It ended the year at 40.
 - Comments: What can I say? I never thought the VIX could get to 100, but the international crisis of liquidity was financial rather than terrorism, oil, or catastrophe based.
- Oil will stay in the \$80-120 range (initial cost is about \$95/barrel)
 - Results: Wrong. A barrel of oil was as high as \$147 and in the last week of the year has been lower than \$40.
 - Comments: Only with time will we know how much speculation had to do with the high prices of oil, and how much deleveraging had to do with the low prices. As alternative sources of energy are not keeping pace with demand it seems hard to imagine a long-term price lower than \$80 per barrel.
- Credit risk will increase with unintended consequences as the sub-prime crisis plays itself out – watch for commercial mortgages and junk bonds, along with CDOs and credit default swaps, to struggle in 2008. My worry is what unintended consequences remain from this bubble. I did not anticipate the impact on liquidity that required the Fed to bail out the economy with lower rates, increasing the risk of inflation and lowering the dollar's value. I am hopeful that the investment bankers learned more this time than they did from the manufactured housing debacle that preceded it.
 - Results: I give myself double credit for this one. ☺ Private equity funds and hedge funds took much of the hit in 2008 but commercial real estate is really struggling now and commercial mortgages will soon follow. Junk bonds will continue to struggle. The unintended consequences I worried about a year ago turned out to be liquidity based. The impact of credit default swaps on AIG and the insurance industry (and the American taxpayer) is still playing out, but will lead to consolidation in 2009 and beyond much as we saw in the banking industry in 2008.
 - Comments: More to come here.
- Home building sector will finish bottoming and level or slightly improve depending on interest rates (up would be worse) – we'll try this one again this year. I think I was just a little early in 2007.

- Results: Wrong. The home market is starting to bottom in some markets, but I continue to be early on this one.
- Comments: We sold a house in 2008, and it took longer and we got less than we would have expected a year earlier. But we were able to sell it, so my experience shows the markets have not totally locked up.
- The dollar will bottom out as oil prices stabilize. Other scenarios focus on countries who are heavily invested in dollars, such as China, Japan, and the oil exporters, choosing to dump dollars. US Treasuries would then spike and the US economy could find itself in a vicious cycle. This may take several years to play out and will impact the stock market heavily. The wild card here is the subsidization of ethanol in the United States. If these subsidies are reduced, the price of oil will temporarily increase, although that would open a financially feasible market to the oil held in the Rockies of North America and ultimately create a cap to the price.
 - Results: Oil prices did not stabilize, partly because the dollar became the currency for safety and rose after falling for most of the year. The fact that other countries are just as screwed up economically as the US kept the dollar from falling further. This long-term trend will begin again in the next year or two.
 - Comments: Ethanol subsidies drove food shortages in some parts of the world in 2008 and remain a bad idea. We have politically popular alternative sources of energy rather than that driven by the scientific community. If we don't change this other countries will.
- I have a fear that the Benazir Bhutto assassination was only the first of numerous events over the next couple of years. Whether this is a repeat of 1968 remains to be seen. I worry for the Presidential candidates in the US in 2008. We should pick our Vice-Presidential candidates carefully.
 - Results: Thankfully this concern has not played out.
 - Comments: It was interesting to see the Republican Vice-Presidential candidate, Alaska Governor Sarah Palin, become such a focus of the campaign.

Emerging Risks - Concerns

- Pandemic influenza – business continuity, impact on small businesses, combination with malaria/AIDS in Africa
 - Comments: not much is happening here, either in preparation or the threat itself.
- Infectious disease - increased resistance to drugs like antibiotics (e.g., tuberculosis, staff infections or pneumonia)
 - Comments: bacteria continue to increase resistance to existing drugs.
- Global warming – unexpected side effects like new viral/bacterial attacks, along with coastal flooding and increased hurricane activity
- Terrorism

- Principles-based capital in the financial services industry will be abused by some and will not be caught initially by peer review
 - Comments: political pressures tied to AIG and the federal charter discussion are leading the US to stall out on PBA initiatives. Recent relief was granted but the standard scenario remains for variable annuity products.
- Can an internal CRO be strong enough to stand up and be counted, or will fears for their job keep them “in line”
 - Comments: see my Chief Skeptical article (December 2008 newsletter) – unfortunately little progress has been made at large firms (although smaller firms are making progress)
- Tort reform needed
- US gridlock/ presidential campaign
 - Comment: the election is over and Obama is in his honeymoon period. Hopefully his financial team will do better than their predecessors.
- Malthus – too many people, not enough food – will ethanol subsidies result in starvation for the poor?
 - Comment: with the Gates Foundation and others keeping more people alive in third world countries, how will they be fed? Will there be unintended consequences of a whole generation of young males looking for something to do? Will Pakistan become a model for failed states? Are these policies short sighted?
- Economy – risk of stagflation and the lack of internal hedge for investors holding both equities and bonds
 - Comment: this year high quality bonds did better, but the threat of inflation based on the large stimulus packages will hit bonds hard.
- Counterparty risk – it is currently so concentrated that one misstep could have major repercussions. Watch the credit default swap market. Much of the economy is now concentrated in a few parties. This leads to more contagion in the system and more correlation in the tails. Financial experts seem to either rely on models that aren’t accurate in the tail or focus on top line rather than bottom line growth.
 - Comment: 2008 was the year that this statement came true in a big way. Weapons of financial mass destruction indeed.

Top Actuarial Issues

- Defined benefit plan valuation – needs to reflect marketplace economics. Actuaries from other disciplines should be welcomed, along with those from outside the profession. Focus should be on cash flows rather than regulatory issues.
 - Comment: this is getting worse, with municipal plans and for profit firms pretty much toast in the long run. Making assumptions above about 5% for future asset growth is irresponsible.

- Demographics – designing a retirement insurance product that is economically sound
- Obesity – how will the various drivers of mortality and morbidity interact (some good, some bad)
- Lack of rudimentary knowledge of assets and how to value them – need teaching sessions that are short of stochastically based financial economics
 - This became even clearer in the past year, and now the Madoff Ponzi scheme has confirmed how important transparency is. People have made fun of me for not wanting to invest in mutual funds because I did not know what was really in them except for certain predetermined dates (end of quarters, and even that is delayed). For a great example of this, look at Berkshire Hathaway’s stock price the last two hours of trading on December 31 and the first two hours in the following year. Everyone needs a reputable accounting firm to audit them if they are investing for the public. The marketplace needs to require this.
- Peer review – how to make it extend beyond a regulatory requirement to help manage the business by identifying and exploiting advantages
 - Comment: We are not making progress here yet.
- National health care – need actuarial solutions
 - Comment: It will be interesting to see if the Democrats use a single payer system as part of the economic stimulus package.

Warning: The information provided in this newsletter is the opinion of Max Rudolph and is provided for general information only. It should not be considered investment advice. Information from a variety of sources should be reviewed and considered before decisions are made by the individual investor. My opinions may have already changed, so you don't want to rely on them. Good luck!