

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 to choose from. 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 2009

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!

These predictions were made in December 2008.

- **Economy:** the political cycle, with Barack Obama about to be inaugurated as President of the United States, has led to a guarded sense of optimism. I think there is reason for hope, but the volatility and tough times will continue for a while. Obama will need to make some tough decisions, and the tone he sets regarding personal accountability versus political expedience will last for years. World economic cycles play out over many years. While the US has had many financial missteps lately, there do not appear to be other countries doing better. We are entering an era where saving will become more popular. This is a positive long-term development, but in the short-term could lengthen the tough times. Fiscal spending will help, but these funds will need to be spread around. The economy is likely to contract until someone figures out a way to loosen the credit markets. Businesses need loans to grow. These loans need to be available for small businesses as well as large, publicly owned, firms. The budget imbalances will require future tax increases, and there will need to be a balance between tax

- collection and incenting people to work. The Beatles wrote Tax Man for a reason. British rates were 90% at the highest levels and there was not much incentive to work. There are many physical disasters that could happen, and one could stimulate the country to work together and move past the current crisis. I continue to be worried about unintended consequences of actions today, with the FHA and FHLB on the radar. I expect the economy to struggle but start to recover by the end of 2009, with the stock market starting to recover in the second half. Inflation will remain low, although the seeds of inflation are already planted.
- Results: Correct. I think I got this one pretty much right. Obama took us from the brink of systemic ruin, but did so using political expediency, in particular with union issues and by staying away from tort reform when redesigning the health care system. It looks like something will now pass, but it will not reduce costs. More on that later. The economy has rebounded from the absolute freeze up that was the latter part of the Bush administration. Jobs are not growing yet, but the stock market has had larger positive gains than I expected. The dollar's fall was interrupted by the flight to safety and the fact that other countries were just as bad off as the US. The long-term trend is still down. The loan market is still locked up, but are starting to thaw. Some markets are changed forever, while others will evolve to a less chaotic state. FHA is already on the hot seat with some worried they will be the next Fannie and Freddie.
 - Comments: the seeds of inflation have indeed been sown, but it will take time for them to grow. This reminds me of the guns and butter arguments from the late 1960s that led to high inflation a decade later. Writing this newsletter is helpful as it forces me to think long-term. When the world seems to be coming to an end a longer time horizon provides a competitive advantage.
 - Volatility will stay above long-term averages, although it should fall back from the current 40. The new norm will be about 20 versus the historical 15-16.
 - Results: Correct. Volatility has fallen back to the 20-25 range much more quickly than I expected. It is currently at the lower end of this range.
 - Comments: it makes no sense to me that volatility should be back at historical ranges at this point in time. There is a market imbalance, but is it due to hedge fund problems and reduced trading or some other reason?
 - Oil will rise above the current range of \$40 per barrel. I believe its long-term mean reversion rate is in the \$80-110 range, but recent volatility has made any predictions very risky. If oil prices do not rise, political instability in Russia and South America will quickly follow in the next couple of years.
 - Results: Correct. Just as \$140 per barrel was a market anomaly, so too was \$40 per barrel. Currently prices are above \$70.
 - Comment: As the world economy improves the price of oil should increase. The interesting dynamic will be whether natural gas takes market share as a green substitute as well or if the world continues on as if nothing has happened.

- Credit risk will continue to play out – commercial mortgages and junk bonds will especially impact smaller firms, while CDOs and credit default swaps continue their negative cycle. Hospitals are at risk in 2009, along with municipalities who have offered more than they can pay in benefits (especially defined benefit pension schemes and post retirement medical benefits). Junk bonds might be worth looking at by the end of 2009 as spreads will be wide and the credit cycle may be about to improve.
 - Results: Correct for the most part. Commercial mortgages continue to be hit hard and several REITs have gone bankrupt. Municipalities are now recognizing their difficulties, driven by defined benefit pension plans, politicians who see no risk in problems that occur after their watch is completed, and unions who overreached their needs. The next step is for local newspapers to use investigative reporting to make the process more transparent, and this has started. Post retirement benefit costs have not been showcased yet. CDOs have been a disaster. Junk bonds rebounded earlier this year.
 - Thoughts on Credit risk:
 - Why didn't the government place capital in the shells of insolvent banks? By giving the money to undercapitalized banks, it was not surprising that they used the money to maintain their ratings. The new leaders at Treasury (mainly Geithner) need to think outside the cube.
 - Comment: More is coming out now about how quickly decisions were made and how little thought went into them.
 - AIG – why were these CDS contracts not allowed to go belly up? Anyone who entered into them accepted counterparty risk. The American taxpayer has already paid in \$150 billion. Certainly closing the contracts at the point of bailout could have been done. Who will feel badly for the hedge funds that would have made more profits? The problem is that banks also were heavy buyers and the government was already committed to keeping them solvent. The government seems to operate as if defaults are not part of our system. Capitalism needs defaults in order to work. This does not mean that workers should not be given help to be retrained. Personal auto industry story – growing up in Detroit and hearing that people were making lots of money to turn a wrench, I was always amazed that they did not save more money or work on other skills for when the gig was finally up. It was not sustainable, and the car companies deserve no sympathy from the American public. The movie Tucker shared a typical example. John Dingell (Democrat from my home district in Michigan) married a Ford lobbyist yet claimed this did not impact any of his votes in Congress. Also, why were employees from Goldman Sachs present at high level Treasury meetings in 2008? The perceived ethics are

questionable, especially when Treasury Secretary Paulson was formerly Chairman and CEO at Goldman Sachs.

- Comment: Not sure what I could add here, except to express my dissatisfaction that it was not hedge funds primarily but investment banks that received my tax dollars. I still think that AIG will be allowed to go under once Goldman Sachs has its money.
- Bank consolidation will continue, with mid-sized and smaller banks merging to gain economies of scale and consumer trust.
 - Results: Correct. TARP money has recently been paid back, but the FDIC is under water and consolidation is occurring as the FDIC uses tax dollars to pay off bad debt and sells bad banks to other banks.
 - Comments: We have a ways to go with this, especially if the agriculture cycle go south.
- Insurance consolidation will accelerate, with household names as well as smaller firms being merged into other firms. Larger, supposedly sophisticated, firms accepted the investment and product risks knowingly, and many smaller firms were led along with the crowd to the cliff by statements like “all the sophisticated insurers are doing this”.
 - Results: Wrong, but early. Many insurers were up for sale, but the problems were wide spread and there were no buyers. Insurers, especially those who write variable annuity business, had little capital to spend.
 - Comments: As the markets rebound for insurers, consolidation will accelerate. Expenses are too high and industry overhead will need to be reduced. Principle-based approaches to capital (PBA) will help this to occur if it is put in place.
- The dollar will revert to its trend and fall based on imbalances in our trade and borrowing policies. Other scenarios focus on countries heavily invested in dollars, such as China, Japan, and the oil exporters, choosing to dump them. US Treasuries would then spike and the US economy could find itself in a vicious cycle resulting in stagflation. This would take several years to play out and would impact the stock market heavily. Various energy subsidies will play out here, from ethanol subsidization to wind farms, with unintended consequences following the well intentioned efforts of politicians (latest example is forcing auto makers to make “green” autos). Watch for others to make vehicles that people will buy, making it even tougher for the auto industry to survive.
 - Results: Wrong, but early. This hand will play out over a decade, not in one year.
 - Comments: Cash for Clunkers is a great example of a program with unintended consequences. While there is a group of people that only buy new vehicles, what are the people supposed to do that normally buy the cars that were destroyed? They will either wait, keeping their previous super clunker, or buy something older. That will clean the skies!

- Political instability throughout the world will be a problem, driven by the liquidity crisis, price of oil, and/or terrorism.
 - Results: Wrong. This has not been as big a deal as I expected. The crisis has led nations to rally around their existing leaders. If the economy improves around the world this might come into play again.

Emerging Risks - Concerns

- Can an internal CRO be strong enough to stand up and be counted, or will fears for their job keep them “in line”. Every firm needs a Chief Skeptical Officer.
 - Comments: I’m not aware of examples where contrarians were welcomed as adders of value.
- Tort reform needed – the world continues to become more litigious at its peril
 - Comments: no change
- Infectious disease - increased resistance to antibiotics (e.g., tuberculosis, staff infections or pneumonia)
 - Comments: closer every day.
- Global warming – unexpected side effects like new viral/bacterial attacks, along with coastal flooding and increased hurricane activity
 - Comments: More studies but Copenhagen conference was a dud.
- Terrorism
 - Comments: ever present threat.
- Earthquakes – the US is overdue for a major quake on the west coast and other areas not normally expected for seismic activity are well into their cycle
 - Comments: limited US impact in 2009.
- Principle-based capital in the financial services industry will be abused by some and not always caught initially by peer review. Currently it is doubtful that the US will have a major influence on PBA worldwide due to the NAIC’s political games.
 - Lots of games but nothing has passed yet. SOA research project will help companies better understand the implications of implementation.
- Home building sector will finish bottoming and level or slightly improve over the next couple of years depending on interest rates (up would be worse). It is probably time to buy stocks in materials firms that serve this market and have low debt. Discussion will start in the next couple of years about a tax overhaul that could include a reduction of the mortgage deduction. Perhaps the AMT will form the model tax law and many deductions will be eliminated. While this might be good incentive, it will hit the home market hard.
 - Comment: housing market is bottoming but there are some regions with huge supply. Lower end of the market will come back first.
- US political environment – can they say no to anyone requesting a bailout?
 - Comment: they haven’t yet.
- Malthus – too many people, not enough food – will good intentions of the rich to save lives in the 3rd world lead to mass starvation or unstable regions?
 - Comment: still a future risk despite genetically modified seeds.

- Economy – risk of stagflation and the lack of an internal hedge for investors holding both equities and bonds – bonds seem particularly challenged right now as rates are low
- Pandemic influenza – business continuity, impact on small businesses, combination with malaria/AIDS in Africa, Tamiflu overuse – watch for the first cluster that involves a doctor or nurse to implement a preconceived plan
 - Comment: pandemic hit in the spring but so far has shown to be low virulence. Hitting young, strong, and pregnant as expected.
- Counterparty risk – will losses be allowed? AIG showed where the credit default swap market concentration was to be found. Many hedge funds were swimming naked as the tide went out. Bernie Madoff led a Ponzi scheme right under the noses of many of the world’s largest investors. Much of the economy continues to be concentrated in a few parties, and now the American taxpayer is one of them. This is not a positive consequence and will lead to more contagion in the system and more correlation in the tails. More qualitative analysis needs to be done by financial experts rather than relying on models that aren’t accurate in the tail or focus on top line rather than bottom line growth. Relying on Black-Scholes models to both determine value and confirm prices has been a disaster. If you can’t understand a risk without complicated mathematics it should be avoided.
 - Comment: concentration risk continues to expand.

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. An estimate of fair value of these liabilities should be calculated and shared with stakeholders. Firms had the opportunity to get out of DB schemes when the stock market was up for 5 consecutive years. Why more did not do so shows how little scenario planning was being done. Municipal plans especially are going to default.
 - Comment: starting to see DB plans shut down again.
- Demographics – designing products that are economically sound to both policy owner and company
 - Comment: note that the new variable annuities do not promise so much
- 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. Focus on transparency and peer review.
- Peer review – how to make it extend beyond a regulatory requirement to help manage the business by identifying and exploiting advantages
 - Comment: the past year has shown the necessity of doing this. Transparency in the strategic planning process is key.

- National health care – need actuarial solutions – this may move in 2009 as part of the fiscal stimulus package
 - Comment: indeed it moved, but I don't see where actuaries were engaged in either this or the systemic risk "solution". Many in the industry have well thought out solutions, but unfortunately politicians are more interested in listening to those with more money to share.

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!