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Observations from the 2008 ERM Symposium

The ERM Symposium was held in Chicago during April 2008. As a member of the organizing committee, I always worry about how it will be perceived by attendees. Historically, the organizing committee itself has been the tougher critic. This year's event brought nearly 600 people together who are deeply interested in Enterprise Risk Management. The seminar continues to attract a relatively high percentage of actuaries in comparison to other risk professionals. Even so, we are making progress as more CAS and SOA members are seen discussing shared interests during networking breaks.

I have always thought of liquidity as a combination of several similar items, but never felt compelled to describe them uniquely. Prior to this week, Dr. Bob Mark had made comments to this effect, referring to trading liquidity as distinct from funding liquidity. As with many issues, Bob was absolutely right. As I listened to 4 days of sessions it became clearer to me that trading liquidity is important, but funding liquidity can make a firm insolvent very quickly. Ask Bear Stearns. When firms trade positions, there needs to be a buyer for every seller. That is Economics 101. If the market will not clear at that level, then it will seek a price to match the existing offer to a willing participant. Value investors are often considered liquidity providers, because they buy when the price has been reduced. When working with borrowed money and leveraging results, as many hedge funds and private equity managers do, funding liquidity becomes much more important. When no one is willing to loan money, no matter the price or credit level, those who are leveraged have to sell. They have no other options. Many borrowers rely on rolling this debt over very frequently, sometimes as often as daily. When liquidity dried up, it was discovered that many hedge funds used the same trading strategies. Many were trying to sell the same financial instruments, but there were no buyers. When combined with high leverage, the spiral began. The Federal Reserve tried to instill liquidity into the system by lowering interest rates, with some success.

Key observation number 1: if you rely on leverage, pay for backup borrowing sources. The cost of this insurance should be a part of the returns. If it wipes out your earnings from the trading strategy, it should give the trader (and especially the investor) pause to think.

Key observation number 2 (okay – I already knew this one): investing slow and steady over a long time frame with real dollars is likely to beat a more aggressive strategy built on leverage or shorting the market. It is also much easier on your sleep patterns.

Many in the insurance industry still think that capital is synonymous with enterprise risk management. It seems like many of the larger consulting firms have this view. There is so much more to ERM than this. If you review their papers and comments, liquidity is buried somewhere yet to be determined in the models. Most modelers build the risks in silos and connect them with a correlation matrix. Some companies attempt to correlate as many as 100 different variables! This might actually work if you are considering deeply liquid markets and no effects of contagion. Personally I am not aware of any of these right now. On the asset side Wall Street is having one of its periodic moments of freaking out, so there is limited liquidity there. Liabilities are not traded on a secondary market, so that adds an additional layer of complexity as well. Correlations are expected to remain steady. It does not appear that companies are starting to use the copula methods that are currently being developed yet. That is no surprise, because copulas will reflect contagion in the tails when prices move dependently. This will lower the diversification benefits and increase the reported capital. No company can afford to do that on their own.

Is it different this time?

I had several discussions with financial experts during the ERM Symposium about whether we were in a down cycle, similar to 1980 (remember when a Japanese firm bought Rockefeller Center?), or if this was the beginning of the end of US economic dominance on the world stage. I was somewhat surprised that, in every case, the expert thought we had entered a long term down period that would result in the US being a second rate economic power. After giving this some thought, I think they are wrong. Unless China improves their incentive structure to consistently encourage entrepreneurial behavior I don't see them taking over the world stage economically due to their political ambitions. That does not mean that the US will quickly rebound, especially if the politicians enact protectionist measures similar to the early 1930s. But in the long run, the US system encourages capital to flow to where it can best be used and that is a hard system to beat.

Investment

I expect to include a recurring topic about investments that did not work out – my personal investment mistakes. This month I will talk briefly about Level Three (LVLT). This was my attempt to buy the picks and shovels of the technology industry. This is a reference to the gold rush winners of the 1800s; not the prospectors, but their suppliers. In any case, LVLT was spun off of Kiewit Construction. This should have been a warning sign, but I missed it. Most of the IPO money ended up going to Kiewit as they dug the holes that the internet travels through today. While eventually this company will provide flexibility when fiber optic technology is updated or replaced, the high debt load and lack of pricing power make this unlikely to be the current shareholders. From a high above $100 per share in 2000, it now sits about $3 per share.

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