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How Should a Rating be Used

Ratings are designed to be a relative measure, but no one uses them that way. If they are relative, then the buyer needs to provide the analysis of actual default risk. Yet most users of ratings take historical default rates and assume those will continue into the future. This is likely the best data available. Should the rating agency be able to say they have no accountability for this? Similarly, statutory risk based capital for insurers is meant only to identify those companies who are at greater risk for insolvency. Yet rankings of companies RBC ratios are a regular occurrence. It is a good metric to reflect default risk and map to ratings. Should it be used this way? No research has shown it to work, but again it is the best available data.

Berkshire Hathaway

Full disclosure: I am a shareholder. I also was a shareholder of Burlington Northern Santa Fe, which was recently bought by Warren Buffett's company. While Buffett complained publicly about using Kraft shares to buy Cadbury as not adding value, he also used shares for part of the Burlington deal. The Berkshire price was based on an average of 2 week's closing price prior to the deal's conclusion. Shareholders of Burlington were asked to say whether they preferred cash or Berkshire stock in exchange for their shares. After I voted to take the shares, and on the first day of the period setting the price, Berkshire was added to the S&P 500. Buffett reduced the cost by over 10% due to this fortuitous timing. I can only think of 2 reasons for this timing. One is collusion, with S&P getting something down the road in exchange. The other is lack of due diligence, where S&P should have known this would materially impact the price of an impending deal.

Reputation Risk

Toyota has recently discovered the importance of reputation risk. They should heed the example of Tylenol in the famous case study, doing what is right for the consumer despite short term hits to profit. Spending a lot of money on spin to show there isn't a problem when there clearly is one is not a good long term strategy.

Pandemic Risk

We appear to have mostly avoided a major pandemic during 2009. The challenging part going forward will be to provide the appropriate balance between Chicken Little as too worried and dot-comers not worried enough. Many firms have prepared to some degree but will still be surprised when a major pandemic hits. Some of the learnings were not surprising, that pregnant women and young would be most impacted. Some were surprising, such as the immunity that seems to have been gained from the 1976 swine flu vaccine against this version of H1N1. This leads one to think that a limited number of



virus combinations are present today and could lead to eradication through vaccine until another combination jumps the gap between species.

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