May 2012

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Incentives

I had several opportunities to see incentives in action recently, and no matter the situation it appears people really do perform in ways that are most beneficial to them.

Misaligned incentives

Youth baseball is a great sport, partly because every family has a different view of what is an appropriate time commitment for a 12-year old. Some think 80 games is too much for a young arm (I'm in this camp), and others like the occasional game in a recreational setting. You balance the time commitment with how well the kids play, and try to build them up so their skills will be noticed by the high school coach while not being a taskmaster. Kids will get a lot better if they are practicing because they want to get better than because their parent wants them to get better. Much like it is fun to see the light bulb come on when they first figure out the Pythagorean Theorem, watching my sons and their teammates improve provides great satisfaction.

That's why an early season baseball weekend was so frustrating. My 14 year-old is in his last year before high school and plays several tournaments a month in the spring and early summer. His team was scheduled to play in a large local tournament. The tournament is sponsored by a local firm that has supported youth athletics for many years, and earns a profit. The tournament was to be played on fields in Council Bluffs, Iowa often used for this purpose and rented by the sponsor. My 12-year old's team was scheduled to play 2 games Sunday afternoon at fields owned by the tournament sponsor and rented out to other baseball organizations. All games were played on Saturday as planned, and it rained overnight.

This is where it gets interesting. Apparently the groundskeepers at the fields owned by the sponsor were also being used for the tournament, and there were not enough to prepare both sets of fields. Baseball organizations that rent the sponsor-owned facility have no say in weather related closings. The tournament sponsor announced via Twitter that their owned fields were closed for the day at 7:16 am. It stopped raining soon after that, most of the CB tournament games were completed with a 2 hour delay. Other organizations managed to get their games in throughout the day.

So what are the sponsor's incentives, and are they aligned with the teams that hire them? If you use their fields, you pay even if the game is rained out. I was mowing the lawn when our games were supposed to be played. It turned into a beautiful day, with another round of thunderstorms at 7 pm. They get paid. I lose 2 of my precious home games (20% of my home schedule). They keep the tournament moving.

And what about our other team that had entered the tournament? As 14-year olds, this is their last time through the circuit. They go to high school next year. As non-returners, is that why the two 14-year old brackets were the ones that were eliminated so the younger brackets could finish? They played 2 games (none Sunday) and paid $575, plus another $160 for t-shirts.

I think this is really a blog about reputation risk, because that is what the sponsoring organization risked this weekend. They are a wealth management firm? It takes years to build a reputation and minutes to destroy it, as Mr. Buffett says.

Fiduciary duty

I received my annual funding notice for the defined benefit pension plan where I am "separated from service", according to the ERISA mandated wording used in the letter. While I am discussing this plan because it is the one I get information about, the comments are general and apply to most if not all DB plans in the United States. As of year-end 2011 the funding level is 73%, with a deficit of about $300 million (about 10% of the company's statutory surplus). The key here is that a DB plan is not held on a firm's balance sheet, so the executives who have a fiduciary duty toward the DB plan do not have these results count against them in their own personal incentive compensation results.

Not only are plans 20% and 30% underfunded, these calculations utilize fairy tale like return assumptions. While the asset allocation is included in the notice, the return assumption is not. However you can make a pretty good guess based on recent changes at Fortune 500 firms that the rate is likely north of 7%. According to the asset allocation listed, almost half is included in an insurance company general account. Based on some research I did last year this makes it likely those assets are earning less than 5% and new money is earning even less, a total disconnect to the earned assumption. So what incentive is in place for the fiduciaries to fully fund these plans on a market consistent basis? None. And that's why they don't do it. Until the shortfall is charged against current earnings nothing will change. Another option might be that add-on pension benefits for senior managers would not be payable unless the base plan was fully funded. The fiduciaries will hope the DB plan will earn enough but know that if it doesn't they will be retired by then (seems like that could be another blog).

I once heard a politician make a comment about a union contract that (paraphrased) it would be a problem in 2 or 3 mayor's time, meaning he would be off the watch by then so just wanted the issue to go away. Many governmental entities are in bad shape because of this today, and now it has carried over to the private sector.

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