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Emerging Risks and Currency Wars

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Emerging Risks

As I head into the fall I start thinking about my annual emerging risks survey and what questions might be interesting to ask. I think this year our rotating question will ask respondents to detail the risks they see interacting with population growth. With recent geopolitical activity regarding Ukraine, the South China Sea, Venezuela and European economic woes, along with Ebola and the IPCC report, it will be interesting to see if infectious diseases, climate change and all of the geopolitical risks surge in their response rates.

I am changing the names of three risks this year, although each is designed to make the risk more generic and easier to understand. Oil price risk will be replaced by Energy price risk, Fall in value of US dollar replaced by currency trend, and Blow up in asset prices is replaced by Asset price collapse (stolen from a new term used by WEF).

As companies prepare for ORSA, I will occasionally throw out a question firms should be able to answer. For example, how adverse a scenario should you consider before setting the location of your disaster recovery backup site? One consideration is geographic, as you want to avoid a location that could suffer from the same event. This would most likely be a catastrophic event such as a hurricane or earthquake. Even an area with tornadic activity would want multiple buildings on their main campus in a north-south configuration to reduce the risk. Think about the natural disasters that are prevalent in your region.

The time horizon for thinking about backup locations is longer than typical. While a once per century event may seem long enough, some events happen less frequently that should be considered. After all, if you are planning to develop a backup location 500 miles away from your primary office, why not avoid less frequent events like Mississippi flooding, major storms that move across the northern plains or from the Gulf of Mexico? In fact, I suggest that if you are located in the northern plains that you find a southern spot to avoid the Yellowstone caldera, a super volcano that would inflict pain from Seattle to Chicago, not to mention the impact on food production (hard to avoid).

The world is entering a scary time, with climate change causing much more interaction between previously isolated species. Ebola is on the move, but it is not the only infectious disease we should be worried about. Pandemics can be caused by airborne diseases much more easily than one that requires fluid to transmit, which makes Ebola easier to contain if it travels to an OECD country. The risk there is of overconfidence and lack of training about the severity of the disease. Other diseases to watch for are enterovirus, Marburg, MERS, and the A form of influenza as it mutates between highly contagious and virulent strains. Get a flu shot every year for everyone in your family, and be sure to keep your vaccines up to date.

Currency Wars

This will be a popular topic over the next couple of years. The United States is moving closer to a neutral monetary policy while the rest of the world continues to attempt to stimulate their economies. Especially with the dollar as the reserve currency, this will likely result in dollar strengthening relative to other currencies, with asset values such as equities and oil potentially dropping quickly. If oil drops there are two interesting plots to follow; will the $80 floor hold (US cost to produce makes it less worthwhile to do so below that value) and will countries driven by the oil commodity be able to maintain stability. This means you, Russia, but especially Venezuela. I am very concerned that a low oil price, combined with a slowdown in China, could make South America very volatile for a while.

NAIC Exemptions

I don't understand why the NAIC uses premium to determine size to exempt companies from regulation. It should be combined with assets under management. If I own a closed block of SPDA policies I have no premium yet could have billions of dollars of exposure to risk and complexity. I also struggle to understand how implementation of the new PBA reserve calculations will work when it is just new business. How will assets be chosen? It seems easy to cherry pick assets to hold lower reserves and subsidize new business. Those who subsidize will set the price, just as they do today.

Risk Manager's Job

I must admit that I feel I am losing control of the risk management space. Actuaries are fighting for keys to the quantitative aspects of the job rather than showing that we can manage risk by telling a story to senior management and the board. I see the best practices risk manager having an important role in corporate strategy, thinking through aggregation, interaction and unintended consequences of the current business and strategic plans. Charlie Munger should be the case study for a good CRO.

Pension plan lump sum offer

Each year my former employer is required to send me a report stating if the plan is meeting the required funding levels. This year they also sent me a lump sum offer. This would be valuable to an employee who was barely vested and had few dollars accumulated in the plan. For me, I have enough accumulated benefit that it made sense to take the time to reengineer the offer. Luckily I am not a practicing pension actuary so I am able to focus on the economic value of the benefit. I believe the valuation rate is 5.25%. Their offer assumes a level closer to 6%. So if I take the lump sum I would need to earn 6%, die before my expected lifespan, and give up the federal guarantee on the policy. The mortality table on these plans is being replaced due to longevity concerns, 6%

seems pretty high for breakeven, and a guarantee from a federal bureaucracy that can print money is huge. Three strikes. You're out. I repriced the benefit using the 10 year Treasury rather than 6% to reflect the guarantee and got a number twice the offer. Had they made this offer in 2009 I might have taken it as my returns since then have been over 15%, but the market is overvalued now and rates are more likely to drop than rise.

Worthwhile twitter follows

I started following these people/groups this summer and recommend them to you.
@stratfor
@epsilontheory
@gndsville
@oliverbettis
@riskmarketnews

I have followed the following for a long time and they remain highlights in my day.
@jamesgrickards
@fivethirtyeight
@thegenevaassoc
@setarcosllc
@johnfmauldin
@mungerisms
@alephblog
@econstories
@erniegoss
@dingramerm

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