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Risk Mitigation, Tax Efficiency, Positive Operational Risk, and Coaching

By Max J. Rudolph, FSA CFA CERA

Risk Mitigation

There are many forms of risk mitigation. Some are financial and private, like reinsurance. Others are financial and public, using publicly available tools like derivatives. Some are harder to quantify, like hiring practices that discourage theft. How do you know how much would have been stolen from the cash register? Some are based on training. The list goes on.

In all cases, risk mitigation deals with downside risk. You are trying to reduce a risk that has been accepted. The accept/avoid discussion is past.

How does this compare with risk arbitrage? We know that tax arbitrage uses holes in the tax code to generate low-risk earnings. Corporate owned life insurance is one example, where the premiums are deductible and death benefit tax free so as long as the tax benefit is greater than the insurer's profit there is money to be made. Financial arbitrage in general takes advantage of price disconnects between markets. Buy in one market, sell simultaneously in another, and lock in risk-free profits. In this example the two markets become more in sync so there is a common good created.

Risk management, and risk mitigation in particular, have many similarities with arbitrage.

Tax Efficient Investing

Personal investors generally have qualified and non-qualified accounts. The qualified, using account types such as IRA, 403(b), and 401(k), accumulate tax deferred and have rules for taking the money out during retirement at earned income tax rates. They are generally funded using tax deferred income. The investor does not have to keep track of capital gains or dividend income received, making it a natural home for bonds, dividend paying stocks, and assets with short expected stays in a portfolio. I don't recommend day trading, but if you want to try it you should use a qualified account.

A non-qualified account is funded with after-tax funds and pays annual taxes on unearned income and capital gains. As the investor thinks about tax efficiency it makes sense to keep buy-and-hold, low/no dividend stocks, in this account. This can be hard to manage if your only qualified account is managed by an employer, but a rollover 401(k) can help this strategy a lot.

Positive Operational Risk

Over the years I have heard many risk managers talk about the downside of operational risks, but I believe we should start thinking opportunistically about them and looking for the upside.

An example is found in the hiring process. If I am trying to hire salesmen, I might have a goal of hiring 6, with flexibility to hire 4 to 8 depending on the quality of the applicants. If I find 8 that I really like then I should hire them and be happy I did so.

This topic should be expanded into a longer paper at some point.

Mental Coaching of Athletes

There are a lot of books written about motivation of athletes, convincing them that they can perform as never before if they only work hard. These books often have material that can be used in business as well. While this may be a stereotype, the books are easy reads and generally not very long. My son received two books by Jon Gordon, a leader in this genre, for his high school graduation, and I read them. As an aside, due to the many similarities between these types of books I suggest reading one every 2-3 years and not back-to-back.

The Hard Hat, written in 2015 and describing the work ethic of a Cornell men's lacrosse player who died during a game, is a good example of friends maintaining a legacy that defines a group that follows them. I liked a quote on page 51. *The key to success is to be a lifelong learner who continuously works hard to improve. When you stay humble and hungry and focus on the process, you will love what the process produces.* Over and over we hear championship coaches talk about how they don't focus on wins or losses, but rather on getting better every day. It's good advice for athletes, parents, students, employees, in fact for everyone who is capable of learning.

The second book was written by Gordon in a tag-team effort with Mike Smith, former head coach of the Atlanta Falcons, and is titled You Win in the Locker Room First. Smith used Gordon as a motivational expert with his team, and the book recounts how the process led to early success and later how they got away from the process and their success abandoned them. The discussion focuses on the contrast between the two eras, with a core dialogue about culture. This is another of my favorite risk management topics so was excited to see it described with so much importance here on page 1. *Culture drives expectations and beliefs; expectations and beliefs drive behavior; behavior drives habits; and habits create the future. It all starts with culture.*

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