Shutting eyes on Dirty White Swans

If a value-based approach to risk management is adopted, Black Swan hedges won't be too expensive to be practical

By **CLAUDIA ZEISBERGER** and **DAVID MUNRO**

REUTERS

Identifying the unpredictable: *In today's corporate environment, there is not much career upside in identifying and hedging a risk that does not materialise. Those efforts will, in hindsight, be seen as a drag on profits. Yet, unhedged risk that takes the industry down with it can easily be explained as a Black Swan, thereby minimising personal responsibility*

CHILDREN have a wonderful ability to shut out the world around them. Just watch as they close their eyes, cover their ears and howl their endless chant, "I'm not listening to you!"

Who would have thought that adult bankers, regulators, politicians and investors would employ the same method to avoid hearing the obvious about financial markets and later claim the existence of Black Swans as their defence?

Black Swans are infrequent events of extreme consequence that cannot be predicted in advance, but are easily explained with hindsight.

Ever since author Nassim Taleb introduced Black Swans into our lexicon and after the devastating financial events of 2007 and 2008 supported his thesis, corporate risk departments, hedge funds and individuals have been searching far and wide in a Don Quixote-esque hunt for the elusive bird.

But most Black Swans are just Dirty White Swans. They catch us by surprise, but shouldn't. This is due to our human bias to dismiss obvious evidence, restrict historic observation to our personal set of life experiences and refrain from hedging an identified risk believing that it probably won't occur.

No One Would Listen is the title of a book about the Madoff Ponzi scheme written by the persistent whistle-blower Harry Markopolos. He caught on to Madoff's ways 10 years ago by recognising the near mathematical impossibility of generating the return series he announced year after year. He shouted at the US Securities and Exchange Commission and served them documented evidence of the fraud, but they closed their eyes and tightly cupped their hands over their ears and shouted: "I'm not listening to you!"

To the regulators plus individuals, pensions, endowments, charities, corporations and funds which lost US$65 billion, Madoff was a Black Swan. To those who listened and conducted basic due diligence, Madoff was just a Dirty White Swan.

Why are we sometimes blinded by the obvious? The answer: profits. The sellers of credit protection were more profitable than the buyers, the buyers of houses increased their net worth faster than the sellers and the bankers with the most leveraged balance sheets took home much larger bonuses than their more conservative peers – until all asset prices collapsed. When the profits rolled in, those warning of potential disaster were ignored. No one would listen.

Aside from ignoring the obvious, we ignore documented history. The Basle II market risk framework helps us in this respect by requiring value-at-risk calculations to incorporate a minimum one-year historical observation period. For many risk managers, the minimum becomes the maximum and historical means last year.

In INSEAD's Risk Management classes, students analyse a case study on Long-Term Capital Management (LTCM), the infamous hedge fund that failed spectacularly in 1998. Almost all cite the lack of a previous Russian default as a reason LTCM's risk models failed to consider sovereign default as a possible outcome.

But Russia defaulted on its sovereign debt following the 1918 revolution when the Bolshevik government refused to pay Tsarists' debt, and did not reach a final resolution with its creditors until 1987 – 69 years later. (Reinhart and Rogoff's detailed history of financial folly in their recent book *This Time Is Different* goes into greater detail) Russia also defaulted in 1839 and again in 1885.

But it's not just Russia. Latin American nations clearly had trouble with creditors in the early 1980s, and Spain defaulted seven times in the 19th century alone. Reinhart and Rogoff counted nine French defaults from 1558 to 1826 and as John Mauldin notes, "the history of Greek debt is not a good one. They have been in default for 105 years of the last 200".

Greece's default in 1826 shut it out of the international capital markets for 53 consecutive years. It's déjà vu all over again, as Yogi Berra said.

Does anyone in finance recognise that history predates their personal experiences? Do firms need to add a chief historian position? Apparently, for some seasoned investment professionals, even personal Black Swan experiences are excluded from their risk management scenario analysis.

LTCM's 1998 problems may have come to a head with the Russian default, but their leveraged fixed income relative value spreads were the real ticking time bombs. Oddly enough, LTCM alumnae drank the Kool-Aid a second time when two separate hedge funds run by three members of the original team lost over 90 per cent of their assets under management 10 years later.

The same highly leveraged relative value fixed income trades that led to their demise in 1998 came back to haunt them in 2008. The 1998 Russian default Black Swan was just a Dirty White Swan for history students. The 2008 Fixed Income Black Swan should have been no more than a chickadee for LTCM alumnae.

Is the cost of preventing or risk-managing Black Swans so high that it would be better to accept them as an unfortunate consequence of doing business? Are Black Swan hedges just too expensive to be practical? Not if a value-based approach to risk management is adopted. In May 2007, it cost just 28 basis points per annum to buy Lehman Credit protection via a five-year credit default swap (CDS). In October 2008, 17 months later, Lehman CDS owners received 9,130 basis points, a 16,200 per cent gain. (Lehman creditors received a mere 8.7 cents on the dollar).

The cost of insurance is cyclical. It will certainly be expensive to buy property insurance when the forest fire is raging across the street, hurricane insurance during Katrina or S&P puts when your broker is making daily margin calls. Value-based risk management encourages the purchase of long-term insurance when it is needed the least and cost is minimal.

In today's corporate environment, there is not much career upside in identifying and hedging a risk that does not materialise. Those efforts will, in hindsight, be seen as a drag on profits. Yet, unhedged risk that takes the industry down with it can easily be explained as a Black Swan, thereby minimising personal responsibility.

It is also difficult to take a contrary stance when executive management claims a risk is unlikely and therefore need not be hedged. An outsider, with credibility, is often needed to call a spade a spade.

Most of what we call Black Swans, unpredictable events with massive consequences, are in reality just Dirty White Swans; entirely plausible and hedgeable events if you study history, perform basic due diligence, employ value-based hedging and listen to those highlighting dangers.

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Corporate strategies – the art is in the execution

By **ROBIN SPECULAND**

IN the last 50 years, man has walked on the moon, split the atom and spliced the gene. In the last 20 years, in business, we have discovered how to capture intangible assets along with tangible by adopting a balanced scorecard, invented ways to improve productivity through "Lean Six Sigma" and are learning how to develop our next line of leaders through the use of assessment centres. Why is it we still can't implement our corporate strategy?

We repeatedly fail to execute our strategy and deliver on our strategic promises to shareholders. Maybe it's unfair in asking this question today. Maybe we have not evolved enough in the strategy journey. Consider that there is not even a global common definition in business for strategy.

Today, hundreds of thousands of students in business schools from Singapore to Stanford study the subject and they graduate with an understanding of its importance but not a common definition. Therefore, maybe it is too much to expect leaders to excel at the next stage and to execute the strategy.

But do we have the luxury to wait any longer? The global recession has dramatically reduced the available working capital in many businesses, made customers more demanding and reduced the size of many markets. This has placed additional pressure on leaders from shareholders (and, in some companies, by their board) to deliver on strategy promises.

Due to the pressure leaders are now under, interest in the field of strategy implementation has dramatically increased. To support this interest, numerous articles, blogs and books have started to appear. Most have been shouting about the high failure rate of strategy implementation (implementation and execution are interchangeable) and quoting that nine out of 10 strategies fail to be implemented successfully.

This statistic is not new. This newspaper first published it five years ago in a previous article I contributed. But it has taken time for the business community to realise the cost and implications of strategy failure.

In the past when leaders were failing in the implementation, they threw more money or resources at the problem. The recession curtailed this habit. When implementation continues to fail (which it did more often than not), leaders have typically blamed the strategy and not the implementation. (This has a certain irony, since leaders are responsible for the strategy and staff members for taking the actions to implement it!) Leaders are in fact shooting themselves in the foot. But I am afraid to say it still doesn't alter their habits.

Another part of the problem is that when strategy implementation does fail, leaders are seldom held fully accountable. To cover up the failure, they quickly adopt the next strategy or blame market forces: "It's the recession" or lower the targets to create an illusion of success. These factors have all contributed to why there is such a high failure rate.

The recession, however, is putting a stop to these bad practices as it places greater pressure on leaders to deliver on their strategy promises.

Another major contributor to the high failure rate of implementation is that leaders have been habitually underestimating the implementation challenge. Some have treated crafting strategy like any other project and once they have completed it, they move on to the next project (mostly ignoring the implementation). Leaders are only paying lip service to the implementation and as a result the staff members only pay lip service to it.

When a company has the ability to implement, what I refer to as "excel in execution" it is a competitive advantage. The Palladium Group, for example, states that it has seen companies excellent in execution create a 100 per cent increase in shareholder value in two years, grown revenue by 21 per cent and reduced operating expenses by 14 per cent both in two years.

To excel in execution, however, is not easy. Leaders must address many different parts of the business simultaneously. For the last 10 years, we at Bridges (the company I founded in Singapore and run) have researched both failed and successful implementations from both the public and private sector in Singapore (and the region). From the research, we discovered that implementation required more than just sending everyone on a training programme or inculcating new values or adopting new measures. We extracted that there were eight areas of excellence:

1. People – it is the staff members who implement strategy (leaders are responsible for crafting it and overseeing its implementation)
2. Biz Case – articulating both the numerical and emotional reasons for the change in strategy
3. Communicate – not just explaining the strategy but also telling staff members what actions to take and making sure they are motivated to take the right actions
4. Measure – change the measures to track the new strategy (not the old)
5. Culture – every implementation is unique as every organisation culture is different
6. Process – eliminate non-value adding work
7. Reinforce – support the staff members who support you
8. Review – every two weeks review part of the implementation and by the end of every quarter review the whole implementation.

For leaders to address all of these eight areas simultaneously is not easy, which is why there is such a high failure rate. Leaders must identify the right actions they need the staff members to take and then make sure they are taking them. Act fast. Don't procrastinate in meetings about what to do. As Louis Gerstner told IBM when he took over: "Move fast. If we make mistakes let it be because we are too fast rather than too slow."

I believe that this new decade will see strategy implementation become the new field of business. Its time is now. An indicator of this is the current recognition of the high failure rate. Another is the sudden growth of new books in the field and yet another is that business schools are starting to offer modules in the subject.

In the past, leaders were only taught how to craft strategy but there was no course on implementation. This contributed to the high failure rate (as well as leaders' frustration and high blood pressure!)

In Singapore, for example, SMU today includes a module on strategy implementation as part of its executive training.

Companies which excel in execution outperform their competitors.

The writer is chief executive of Bridges Business Consultancy Int and author of 'Beyond Strategy – The Leader's Role in Successful Implementation'. Visit www.strategyimplementationblog.com

LETTER TO THE EDITOR

Restating DPU figures after a rights issue

WE REFER to the article "Sticking a foot in investors' eyes" BT, April 29). We wish to clarify some of the matters raised by your reporter Emilyn Yap in that article.

Firstly, it is over-simplistic to conclude that it is always wrong for previously-announced distribution per unit (DPU) statistics to be restated after a rights issue. In a rights issue that gives existing unitholders the right to subscribe for say one new unit for every existing unit held, a unitholder starts off with one unit and ends up with two units. If he previously received one dollar of distribution for his one unit, and now receives one dollar for his two units, it is overly simplistic to conclude that each unit is now worth half compared to when he bought it. Taking into account all units held, he still receives the same one dollar. To demonstrate this bonus effect, it is general practice to make a distinction between old units and new units, and restate all per-unit values. In stating the DPU, this will mean that amounts are stated in terms of new post-rights issue units, where each new unit is equivalent to half of an old unit. Your reporter criticised this restatement; this in some way equates apples and oranges as the new units are different from the old units.

Secondly, it is necessary to account for dilution in a rights issue where there is indeed such dilution. A unitholder who currently holds one old unit needs to pay in extra capital to be entitled to hold two new units. If the new capital is held by the trust as idle cash without generating additional profit, the same amount of profit is being distributed although unitholders paid in more capital. To show this dilution effect, DPU figures are computed without restating previous figures. In a rights issue, it would make sense to compute DPU without any restatement of past DPU figures only if the new units are being offered at their full market value, without any discount. Your reporter's comment, that such restatements are always inappropriate, would be valid only if the rights issue involved no discount, which in practice does not happen.

Taking these two points together, a rights issue is a combination of two components: firstly, to some extent, a bonus issue of units and secondly, to some extent, an issue of new units at their full value. As to how much the past DPU figures are restated depends on how much the rights issue represents a bonus issue versus how much it represents an issue of new units at full value.

Such restatement of past numbers is a well-accepted and well-understood treatment in the case of earnings. Singapore financial reporting standards have long mandated the exact manner of such re-computation and restatement, and Singapore companies have regularly made such adjustments after rights issues.

We accept that DPU statistics are not always seen as equivalent to earnings-per-unit statistics, and it might not always be appropriate for a treatment well accepted for earnings to be similarly applied to distributions. In the meantime, we are conscious that financial reporting standards currently do not provide guidance for the accounting of distributions, as opposed to earnings, after a rights issue. As a result, it is possible that inconsistencies in practice have arisen as a result. We are currently reviewing the need for such distributions to be covered more explicitly by financial reporting standards. We hope this will, in time, eliminate the inconsistencies and lead to a better understanding of financial information issued to stakeholders.

Janet Tan (Ms)
Executive Director
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Emilyn Yap replies: The commentary does not object to the restatement of previously-announced distributions per unit (DPUs) after a rights issue. What it disagrees with is how the restatements are presented. Real estate investment trusts should present the original DPUs upfront, not the restated figures, so that unitholders can see the effects of a rights issue more clearly.

It is encouraging to note that a review of financial reporting standards for DPUs is under way.