# Risk Taking

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September 14, 1989

Much good stuff has been written and spoken about choice, managers, markets, currencies, maturity, engineering, technology. What I would like to do here is comment on some basic -- perhaps fundamental -- stuff which places decision-making in finance in some frame of reference. The subject is uncertainty and vulnerability and our capacity to understand and cope with the outside world.

## Subject of Talk

1. Volatility.

2. The bureaucratic setting and our environment.

3. Management. Who is the CFO, the Treasurer, the COO; what does he know about this stuff.

4. Some suggestions.

## Volatility

What has the world's financial system experienced over the last decade or two?

1. Volatile exchange rates. Yen 360, Yen 170, Yen 320, Yen 150.

2. Volatile interest rates. 7%, 15%, 7%, 10% for long-term bonds and 5% to 20% for short-term paper. A market in which the movements over one week were often greater than the movement over 10 years (1955-1965).

3. Basic changes in world patterns and volumes of financial participants. OPEC, Japan, the Euro dollar market -- and who can move the market.

4. A great premium on liquidity -- caused in part by market volatility.

5. Recession; inflation.

6. Deregulation -- across borders -- permitting investors to sell their currency and buy another, and more, move their savings to support another country's infrastructure or private sector -- a remarkable development.

7. Increased communication links.

8. Very high material rewards or compensation for getting it right. Uncertain personal penalty for getting it wrong.

9. Intermediaries who decided to play beyond their trade needs.

Given that environment, the code words are innovate, leverage, protection. But the human psyche, and certainly the bureaucratic setting, has not changed. There remains how we cope with financial uncertainty in a competitive world in a bureaucratic setting.

The Trader -- A Bank or Corporation

1. We respond to peer pressure. Develop and then sell that magic zero coupon bond with a perpetual maturity so a borrower needs pay neither interest nor principal.

2. Capture rewards quickly and visibly.

3. Share blame or responsibility. We seek not to be identified as the provider or unwisdom.

4. We do not measure opportunities lost. Only visible mistakes are punished. Investments made at 8% when yields rise to 12% are considered a mistake. Those not made at 12% when yields decline to 8% are not so considered.

5. There remains a reliance on sympathetic accounting

conventions. You need not show losses until you sell. Performance measures sometimes are designed to cover-up error.

6. Senior management rarely as informed as operational managers.

## Middle Manager

1. Looks for quantitative support -- for charting, for probabilities, for quantitative analysis, to justify, on an objective basis, their views.

2. How much is the loss -- the dread factor. Will we or our client be wiped out if we move too soon or too much.

3. Will we be found out? Discovered. Identified as the wrongdoer -- the recommender of unwisdom.

4. Will we be hassled? By peers, superiors, the bureaucracy.

5. Have we experienced the pain; made mistakes; seen fortunes or lives damaged by unanticipated moves (10% to 16%)? Or, is it referred pain, historical, read about; did we actually experience that sinking feeling? Were you actually on the trading floor when the market moved down

30, up 20, down 50?

6. The herd instinct.

7. The availability of rewards and punishment.

8. Present pleasure -- future pain: let someone else pick up pieces.

## Keep in Mind

The Trader:

1. Can't predict rates. If he could, would not need to work -- ever.

2. Usually little academic analytic skills.

3. Unwilling to hedge.

4. Compensation system
   a. firm's money
   b. no downside risk
   c. double-bets if market deteriorates.
   d. sense of ego (I must be paid so much because I am worth it).