



SOCIETY OF ACTUARIES

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Editor's Corner American Beauty, Enron, and Tails

by Christopher H. Hause



Chris Hause

In the movie *American Beauty*, Kevin Spacey's teenaged next door neighbor makes a living selling high grade marijuana. The teenager's father was a military man and strict disciplinarian. The father apparently accepted that his son had a bedroom filled with high tech audio-video equipment using

When we hear self proclaimed plain-talkers tell us that "if it ain't broke, don't fix it," we are reminded of the fellow hurtling earthward after his parachute failed to open proclaiming that "everything is going well...so far."

It is undoubtedly human nature to believe the path we are taking

Major dislocations are sent our way every day.

Whether we can anticipate them depends on many factors. How we prepare and react to them is all our business. Sometimes a country-western attitude toward life is not what is required, because the world is a rock-and-roll place.

We tend to think of dislocations as only negative. I believe that success equally involves embracing the work of pioneers and visionaries who bring positive dislocations about.

Here are two of my favorite quotes about those who dare to think outside the norm.

"Great spirits have always encountered violent opposition from mediocre minds." *Albert Einstein*
"When a true genius appears in the world, you may know him by this sign: that the dunces are all in confederacy against him."

Jonathan Swift

How do we recognize the "great spirits" and "true geniuses" of the world? How do we distinguish between the visionary and the merely eccentric?

The Product Development Actuary – Using Clarity and Foresight

Our job as actuaries is to provide our companies with the numerical tools to analyze emerging markets, products and opportunities. We provide the business models that demonstrate the interaction and effect of internal strategies and external force.

Experimental products, markets and business strategies require a more-than-normal dose of analysis of the ingredients required for success. Many times we can sort the

"It is undoubtedly human nature to believe the path we are taking leads inexorably to the Holy Grail. Well maybe not the holy Grail, but at least not in the direction of ruin."

money that he earned from part-time jobs. The son's explanation for his ability to fool his father?

"Never underestimate the power of denial."

Fast forward to the congressional Enron hearings where Jeffrey Skilling, the company's former Chief Executive, is quoted as saying, "I cannot for the life of me understand how we could go from where I thought the company was to bankruptcy in such a short period of time. It's astounding."

"Never underestimate the power of denial."

leads inexorably to the Holy Grail. Well, maybe not the Holy Grail, but at least not in the direction of ruin. We may believe this even though the opposite is obvious to the clear-minded observer.

Can it be explained by something as simple as Newton's first law of physics? That we tend to stay on our current path until some external influence forcibly knocks us off course? Or, perhaps foolish pride is the culprit. At times we believe that the road we are on is correct, even though we may have come this way quite by accident.

Impossible Things are Happening Every Day (Apologies to Rodgers & Hammerstein's Cinderella)

We are used to hearing that nothing is constant except change. I believe that statement is too weak. In looking to the future, I think you should start with the assumption that one or more major changes will occur, and be prepared to adjust.



visionary ideas from the eccentric by simply applying our science to the problem at hand.

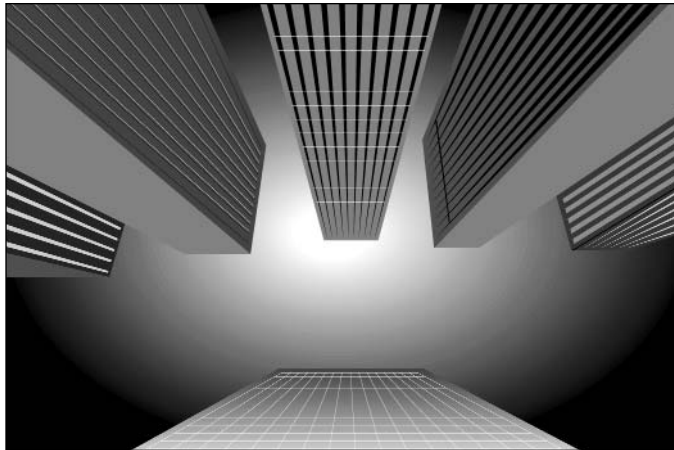
We alone have the tools to quantify a proposed course of action in the way that the securities analysts talk of investments, in terms of risks and rewards. Given proper analysis, our companies can steer clear of the high-risk-low-reward quadrant, and focus on more fruitful opportunities.

In this role, the actuary's advice helps to clarify the vision with analysis and forethought.

Our Financial Crystal Ball and the Tails

The financial reporting actuary has a different, and arguably more crucial, role as visionary. His or her job is to anticipate the unthinkable and preparing for the unlikely.

In 1978, we measured our



liabilities by twenty-year-old mortality and interest rates that resembled savings account levels. The insurance product revolution that followed caused us to look to the future in a more modern, but still largely deterministic, manner.

Now the questions that we are asked are tougher and the answers more complex. Even simple portfolios are vulnerable when major dislocations occur. The "tails" of our stochastic distributions are getting more attention, and well they should be. We are asked to protect our shareholders, our companies and our policyholders from the tails.

We used to think we could ignore the "less than 10% probability" scenarios. It is clear that we must address them. While once we may have appeared to be "Chicken Little" in the board room if we even mentioned tail scenarios, boards and CEOs want to hear more about how we can protect against them.

Perhaps some thought that the possibility of Enron failing was a "tail" occurrence. I would not want to explain to those folks who had their financial future ruined, that I could safely ignore their plight because it had a small chance of occurring. I would rather tell my clients that we are hedged against the tails, and let the world "bring it on."

As we travel down the road of life and commerce, it is rarely enough to focus exclusively on the road straight ahead. Many times the road is anything but straight.

Chris Hause is President of Hause Actuarial Solutions in Overland Park, Kansas. He can be reached at 913/685-2200 or by e-mail at chrish@hauseactuarial.com.

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