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A Look Into ERM

WE MUST LEGITIMATIZE UNCERTAINTY

BY DAVE INGRAM

FOR 20 YEARS the Great Moderation made many of us feel like masters of the universe. Business was not easy, but with a reasonable amount of smart, hard work, it was fairly certain that a well-trained business executive could lead his or her company to success.

But after the twin Internet and housing boom and bust periods, we seem to have slipped into a morass of uncertainty. The *New York Times* used the word “uncertain” 345 times in just one day recently. Selecting a strategy for a firm seems just as uncertain as forecasting almost anything. There was no training and little experience with a prolonged

uncertain environment such as we have been experiencing for several years now.

For the most part, our theories of business and economics acknowledge those booms and busts, but the moderate environment that lasted almost a generation was what is really expected by the equilibrium-seeking world that is the basis for most economic theories. When times were uncertain in the recent past, they did not last so long. We were able to ignore the bursts of uncertainty and just wait for things to organize themselves in a pattern that we could react to.

But the lack of patterns that is characteristic of an uncertain environment actually is a recognizable part of the world that we should expect. And there are strategies that we may already be using that are what is called for in an uncertain environment.

This uncertain environment and the requisite strategy are found in the theory of Plural Rationality (see the articles by Ingram, Thompson and Underwood in *The Actuary*). That theory suggests that there must be four environments to align with the four risk attitudes that are found in human groups.

The uncertain environment is expected by the groups we label Pragmatist. These folks do not expect the world to be predictable. Their preferred strategy is to avoid large or long-term commitments. To diversify their businesses in terms of both the things that they do and the way that they do them, some Pragmatists develop a lottery mentality just waiting for the big random win. More often, however, the successful Pragmatists have worked to make sure that no single random hit will break them while they may have some activity already going in whatever emerges as the next big thing—though usually they are not at all aware of what that might be. Pragmatists also are

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fond of sitting on a nice pile of cash. It keeps their options open—a favorite phrase.

The groups who expect the moderate environment, we called Managers. The Manager’s strategy is to favor the sort of analytics performed by MBAs to support their decision making, because in the moderate environment, many of the activities that can make a profit are fairly complex to get right. (Efficient Market Theory would suggest that the easy choices are already taken.) In a moderate environment, it is believed that highly organized operations willing to put in the work on analysis will be able to reliably discern the best course of action. The Managers may also diversify, but in a calculated, controlled manner. The idea that businesses can be run by generalists is also a manager strategy.

Other groups expect a boom environment. We called them the Maximizers. These groups would tend to be totally concentrated

on their absolute best returning business choice. They tend to run businesses with a high performance-related compensation structure. Success is the ultimate indication of talent and competence for Maximizers. When you have lots of Maximizer groups operating in the same environment they all may end up loading up on the very same “best” choices.

The last group, Conservators, expect the bust environment. Their strategy is to pull back from any risky behavior. “Sticking to what you know best” is their favorite phrase. In business, Conservators do not shun all risks, but avoid taking any new risks that they do not have plenty of experience with.

During the Great Moderation, we had convinced ourselves that we could live forever after in an environment that was moderate, with occasional booms—so much so that even study of a bust was considered an arcane, purely academic exercise. Few if any

business executives had any idea how to lead their companies through that firestorm.

In a post to the *Harvard Business Review* blog, “American CEOs Should Stop Complaining about Uncertainty,” Jonathan Berman points out that while African companies are able to cope with their uncertain environment, American CEOs mostly complain.

But the uncertain environment did not exist in the literature when the American CEOs went to school. Perhaps as the bust environment works its way back into the literature of business and economics, the uncertain environment that we have been experiencing will be discovered as well—and the winning strategy, as practiced by the Africans, of adaptability. **A**

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