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# CENTRE FOR FINANCIAL MANAGEMENT®

## CFM QUARTERLY IN FINANCE

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### PART A : ARTICLE

### PERCEPTION OF RISK

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In his insightful book *Against Gods: The Story of Risk*, eminent financial historian Peter Bernstein argues that the perception of risk throughout history has reflected the temper of times in each society. To illustrate this idea, he discusses how risk was perceived at different times.

- For the bulk of the human history, future was a black hole. People felt that they had no control over the futures as chance explained the outcome of risk taking. So they believed in Oracles and priests, especially the latter because they thought that seers had a direct line to the powers that controlled their futures. However, the random track records and obscure methodologies of these seers inspired little confidence in their forecasts. So their constituents believed what they wanted to, rejecting the rest.
- With the arrival of Christianity, random chance was out. It was replaced by the will of God. As a result, scientific research was crushed.
- For the West, the Crusades which began toward the end of the 11th century was a defining event. With the acceptance of the numbering system the Arabs had inherited from the Hindus nearly a thousand years earlier, people were freed from the constraints of the counting frames, or abacus. A whole new world of mathematics emerged, offering limitless possibilities of abstraction. As the philosopher A. N. Whitehead observed: "The point about zero is that we do not need to use it in the operations of the daily life. No one goes out to buy zero

fish. It is in a way the most civilized of the cardinals, and its use is only forced on us by the most cultivated modes of thought."

- The combination of the Crusades, the early development of trade, and serious geographical exploration made people aware that they had some control over their futures. Choice became a valid human activity and risk was something to be taken and not just something to be faced. As Bernstein put it: "That was what the Renaissance was all about: the freeing of the human spirit for experimentation, innovation, and exploration." Measurement became not only interesting but also essential. Girolama Cardano made the first serious attempt to develop the principles of probability in the mid sixteenth century.
- With the development of the theory of probability a mighty tool became available to humans to grasp the unknown future. Along with it a set of ideas began to take hold that led to the development of utility theory.
- World War I, however, blasted the conventional wisdom of the Victorian and Edwardian eras into smithereens. As Bernstein noted, "A world that had once seemed predictable and orderly turned out to be unpredictable and disorderly in the extreme." No wonder Frank Knight's great book *Risk, Uncertainty, and Profit* was published in 1921. He expressed its central theme in these words: "There is much question as to how far the world is intelligible at all… It is only in very special and crucial cases that anything like a mathematical study can be made." Similarly, another publication of that year, John Maynard Keynes's *Treatise on Probability* challenged the whole idea that mathematics can define the future with any degree of certainty. Later, in the wake of the Great Depression, Keynes wrote: "[Most of our decisions ]to do something positive…..can only be taken as a result of animal spirits…and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."
- The awful world of the 1930s gave way to the optimism of the early postwar years- the 1950s and 1960s- when markets were orderly and risk was regarded as measurable, manageable, and containable. It is no coincidence that portfolio theory, capital asset pricing model, efficient markets hypothesis, and option pricing model were developed during this period. Bernstein refers to this body of theory as classical. As he said, "Although I have not heard anyone refer to this body of theory as classical, its balance, cohesion, clarity, and consistency provide all the necessary hallmarks of classical forms."
- The growing turbulence of the financial world from mid 1980s has cast its shadow over the classical capital ideas. As Bernstein observed, "Today, the classical capital ideas are suspected of suffering from kurtosis, skewness , and other less familiar malignancies. They are under attack from nonlinear hypotheses, overwhelmed by fears of discontinuities rather than pricing volatilities and factors, and frequently made irrelevant by exotic new financial

instruments that come in unfamiliar shapes and hedge unfamiliar risks." He added: "As the mathematics that defines these risks grows increasingly complex, the dimensions, contours, and limits of risk are becoming increasingly obscure."

- In the new environment, the traditional methods of risk management are on the defensive, stimulating the demand for new methods. Bernstein, however, has expressed caution in 1995: "An explosive demand for novel forms of containing risk is developing, some of which, I fear, may in the end make markets more risky rather than less." The global financial crisis of 2007-2009 seemed to vindicate his concern.

Bernstein has elegantly summed up the history of risk as follows:

"Throughout history, the perception of risk has reflected the temper of the times in each society. From the superstitions of the ancients to the strict regulations of the early Christian Church, from the rational views of the Renaissance and the Enlightenment to the upheavals provoked by World War I and the Great Depression, and from the classical concepts of modern portfolio theory to the dark and hidden forces driving us today, perceptions of risk are the most powerful symptoms of what a society is all about."

## PART B : SNIPPETS

### Neophilia and Neophobia

People go through life with two competing motives: neophilia (a liking for new things) and neophobia (an aversion for new things). People vary in terms of which motive is stronger. Liberals are more open to new experiences (for food, people, music, and ideas) and hence score higher on measures of neophilia. Conservatives, on the other hand, prefer to stick with what's tried and true and hence score higher on measures of neophobia.

### Time to Dump Traditional Budgeting

Michael Jensen, an eminent financial economist and organisation theorist, argues that the traditional budgeting system which links bonuses to budgets is severely dysfunctional. He says: "It encourages managers to lie and cheat, lowballing targets and inflating results, and it penalizes them for telling the truth. It turns business decisions into elaborate exercises in gaming." Over a distinguished career in academia and consulting he has gathered a trove of horror stories.

When bonuses are linked to budgets, people resort to gaming. Price discounts are offered to meet sales targets; profits on investments are booked when they have the maximum impact to managerial bonuses; CEOs and CFOs manage earnings in an attempt to artificially boost profits.

How should one look at the practice of stretch targets? Many companies use stretch targets because they believe that such targets prod people to work harder and improve their productivity. Michael Jensen considers such a practice as counter-productive. As he says, “I believe that’s wrong. It’s not that a company won’t get a nominal increase in productivity but the company will also get gaming behaviour which is highly counter- productive and damaging.”

What is the way out? The only way out, according to Jensen, is to sever the link between budgets and bonuses and to reward people purely for their accomplishments and not on their ability to achieve targets. This will take away the incentive to cheat. As he put it: “The only way to solve the problem is to remove all the kinks from the pay-for-performance line—to adopt a purely linear bonus schedule. Managers are still rewarded for good performance, but the rewards are independent of budget targets.”

Arguing in a similar vein, he emphasises the desirability of having performance-related budgets. For example, the manager of a division may be told that he is allowed to spend 65 percent of his division’s revenues on production and sales activities. The variable performance-related budget is similar to the compensation plan described earlier.

How have companies received the idea of a linear bonus schedule? According to Jensen, “People have started to implement it. It’s not easy because it requires a change in the mind sets of managers. It’s a bit like asking fish to see the water they are swimming in.” He added, “In my discussions with managers, I find that many of them simply cannot imagine how they could run a company without setting targets and holding people accountable to meet them. They all recognise the problem but they say it doesn’t exist in their organisation.”

**Long- Term Equity Anticipation Securities (LEAPS)**

Longer- term equity anticipation securities (LEAPS) are publicly traded options contracts that have expiration dates that are longer than one year. LEAPS offer the opportunity for investors to gain exposure to price changes over a longer period- without the need to use a combination of short- term option contracts. Obviously the premiums for LEAPS are higher than for standard options in the same stock since a longer expiration date means that the underlying asset can make a substantial move that enables investors to make a healthy profit.

LEAPS contracts can be on individual stocks as well as the index. LEAPS call option enables investor to benefit from potential rise in a specified stock while using less capital. Investors can sell LEAPS calls anytime prior to expiration and realise their profit or loss.

Stock LEAPS puts provide investors with a long- term hedge if they own the underlying stocks. They can also be used to speculate on a potential fall in the underlying stock.

Index LEAPS allow investors to gain exposure to changes in the underlying index over a longer period of time. Investors with a bullish view may buy index LEAPS calls and investors with a bearish view may buy index LEAPS puts.

## PART C : WIT AND WISDOM

## HUMOUR

### Stories

A young novelist once asked Maugham, “Should I put more fire into my stories?”

“No,” Maugham tersely replied, “Vice versa.”

### Thank You

A chemistry professor in my university was good in his subject, but somewhat weak in English.

One day he was given lift by an attractive female colleague in her car. When he got off, he said, “Thank you.” The colleague said, “Mention not.” He gravely replied, “I assure you, I won’t mention it to anyone.”

### WISDOM

1. Success covers a multitude of blunders. :Bernard Shaw.

2.Success has many fathers and failure is an orphan.

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