THE $5 LESSON FROM THE LOTTERY

by Steve Brown

While $360mm wasn't enough to get our attention, now that the 42c state Mega Millions lottery total is at a record $500mm+, we are in. We have researched it and know which of the 56 balls have come up most often (11, 14, 18, 33 & 48); what numbers are most often played (numbers less than 30 due to birthdays); consecutive numbers and the numbers from the TV show Lost. Yes, we know that our expected winnings have actually decreased since the last play (when no one won) due to the sheer number of people that are now entered. We also recognize that the odds of winning the grand prize are less than 175mm to 1, or about the same as getting 10 holes-in-one in the next golf game. That just doesn't matter, though, because our $5 dollars allows us 2 days of dreams about what we would do with the winnings and that is priceless. Of course, if we win on Friday we will look like lucky geniuses. If we lose, people will laugh and that is where the problem occurs. Too often in banking we tend to judge the risk by the outcome. The one we hear all the time is that a bank feels it made a bad decision on a loan participation. While the bank may have mispriced it or misjudged the risk, most likely the decision wasn't a bad one. Rather, if the loan had problems, it was probably because it was a construction loan; a hospitality property with a higher probability of default; or a loan to a borrower that was already highly leveraged. Loan participations, after adjusting for credit, have exactly the same probability of default than any other loan (with the addition of a little more legal risk and liquidity risk). In other words, it is not that participations can be "bad," but rather that the bank mispriced the risk. Consider that the same goes for insurance. Purchasing insurance is never a "bad" decision, as it only helps to smooth earnings and protect the bank. You can argue that insurance is mispriced, but you can't argue with the concept of protection. If you think insurance is too expensive, then you should self-insure. If not, you should buy insurance. If you have to use it, the risk was the right one and if you don't have to use it, that is even better (as you don't have to go through the event that caused you to use it in the first place). The duality of positive outcomes underscores the point that risk is neither "good" nor "bad" and should be separated from outcomes. Often, this concept works in reverse, as some banks will not buy agency mortgage backed securities (MBS), despite the fact that they have a better risk-adjusted performance than most bank investments. While it is true that if rates move more than 125bp up or down you would rather own Treasuries that is a different decision. If you were to purchase MBS today, the probability of rates going up or down (based on the forward curve) is exactly fifty-fifty. Thus, purchasing MBS can never be a "bad" or "good" decision - it is just a decision. Now, if you already own a lot of real estate or already have too many fixed rate loans or fixed rate loans without prepayment protection, then purchasing MBS may be bad. But, like attributing risk to other things, that is different. Our point is that risk is the relevant factor. It is the accurate judging of probabilities and the impact that we should worry about. Risk decisions are about considering the impact of likely and unlikely outcomes and making a sensible choice from the information. It doesn't matter what decision you make, there will always be times when it looks bad in hindsight. To write a decision off as "bad" or praise it as "good" well after the fact because of an outcome not only misses the point, it undermines proper risk management. The quality of a decision (and indeed, a decision-maker) should be evaluated based on the information available at the time the call was made. Evaluation based on results encourages inefficient decision-making and sub-optimal outcomes that will be either too risky or too conservative. When it comes to risk management, it pays to be clinical in evaluation. Resources should be focused on determining the most accurate probabilities before making the decision. Find out what is known, unknown and assumed about a probability and about the impact on the outcome. As for the lottery, wish us luck!

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