The **arrogance** of hindsight

Some governments are reportedly becoming more active in using derivatives to manage their debt and funding costs. While arguably quite sensible, public distrust and sensationalist journalism present special dangers, argues ***David Rowe***

As reported in this month's issue of *Risk* (see page 18), some sovereign debt issuers are starting to use derivatives more actively and openly in managing their debt costs. Most readers will welcome this as an overdue adoption of tools that have long played a constructive role in the private sector. While I agree in principle, it should not be forgotten that such an innovation will unfold within a political hothouse of suspicion and misunderstanding.

I recall a story more than 20 years ago about a US state pension fund officer who left to set up a private investment advisory firm. The trigger for the story was how his firm was earning several times his former compensation by providing services to the pension fund he left. That alone, however, would have made the story fairly innocuous given that the adviser's fees were consistent with those paid to its competitors for comparable services.

What added extra sizzle, and undoubtedly sold more papers, was the fact that this adviser's portfolio had lost considerable money for the fund. The headline was something like 'Former pension fund employee cleans up while costing taxpayers dearly'. Like far too many news stories, this was a literal truth that conveyed a blatant falsehood. You had to read the details of the article to learn the whole truth.

It seems the pension fund staff had become nervous about an extended bull market in equities, and engaged the former employee's advisory firm explicitly to structure a countervailing position to cushion the impact of a potential downturn. When the market continued to rise, this position naturally lost money. Indeed, if the position had not lost money the adviser could rightly have been accused of abusing his mandate.

David Rowe is executive vice-president for risk management at SunGard-Adaptiv. Email: david.rowe@risk.sungard.com

Risk and uncertainty are second nature to those who are actively engaged in financial markets. This makes it hard for us to fathom people who don't think in the same framework. Clearly, however, many of our fellow citizens fall into this latter category. How else can we explain the constant belief that someone always must be to blame whenever anything goes wrong? (*Risk* March 2005, page 50.)

Of course, malpractice, criminal negligence and even malicious intent do exist, and a willingness to assign blame where appropriate is essential. Nevertheless, many adverse events stem from taking calculated risks that made perfect sense before the fact. One might call this the arrogance of hindsight: given what has happened, how could anyone be so stupid not to prevent it?

Clearly, public perceptions have evolved since 1994, when derivatives became a derogatory term in the aftermath of the Barings Bank failure and the controversy surrounding losses at Gibson Greeting Cards and Proctor & Gamble. Nevertheless, public understanding of derivatives markets and the valuable role they play remains minuscule at best. If such understanding was any higher among general business journalists, it could make an important difference. Sadly, even in those circles, excluding specialist trade publications such as *Risk*, understanding remains poor.

Combine poor understanding of derivatives with the pervasive suspicion of government and financial markets, and you have a volatile environment indeed. Stories of wealthy investors losing millions in a hedge fund failure may inspire a sense of *schadenfreude* among readers, but such stories are unlikely to cause widespread outrage. The impact is too narrowly distributed, albeit serious for those affected.

It is easy to imagine the sensational journalism that would follow a sovereign debt office losing money on a derivatives trade, however. It may well be that there was bad judgement or excessive risk in the transactions based on *ex ante* information. Perhaps there was an attempt to cover a deficit with gains on speculative market investments. Somehow, I doubt the story would be viewed so analytically after the fact. Even if the positions represented responsible hedges against circumstances that did not arise, the news reports would certainly highlight the losses and seek someone to blame.

Persistent efforts to raise public understanding of uncertainty and how to judge after-the-fact results without the arrogance of hindsight cannot hurt. Unfortunately, any such efforts will face stubbornly entrenched ignorance and prejudice among both the public and much of the media. This is surely why use of derivatives by sovereign entities has been so limited to date. Any move to expand such use needs to be accompanied by a careful programme of public education. Even then, however, I suspect the political consequences of anything going wrong will be magnified by the public's minimal understanding of the role of derivatives. ■