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COMMENTARY: THE WEEKEND INTERVIEW

Risk Manager

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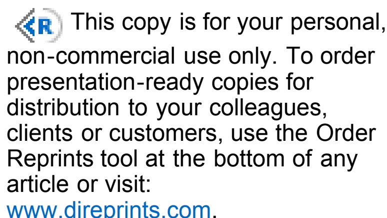

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RYE BROOK, N.Y. -- What some called the "goldilocks" market got a sharp rap upside the head this week. Why can't things always be smooth and nice and predictable? Myron Scholes, operator of the hedge fund Platinum Grove Asset Management, says you wouldn't like it if they were.

Ismael Roldan

You know him better as a winner of the Nobel Prize in economics. You may also recall him as a principal of the hedge fund Long Term Capital Management (LTCM), which went belly-up in the late 1990s. Indeed, to the authors of a certain type of financial potboiler, he'll always be the mad scientist who almost blew up the world.

A better description would be a lifelong student of risk, and why we humans need risk, how we manage it and why we'd be unhappy without it.

Start with the commonplace that risk is one side of a coin whose other side is reward. "We all have a taste for it," he says. "In life, it would be kind of boring if there was no risk. On the other hand if there's too much risk, too much uncertainty, too much chaos, we can't handle it either. We simultaneously want order and disorder, simultaneously want risk and quiescence."

Our conversation, at his suburban New York headquarters, takes place just before the recent market gyrations, but his analysis has a greater ring of verisimilitude than many that filled the media this week. "Right now," according to Mr. Scholes, "we're quiet because the lion is tame, and maybe it's the central bankers of the world who are keeping it tame." And thus, "Individuals will say, oh, things are now quiescent and will be forever, and they'll take more risk again."

He adds: "My belief is that because the system is now more stable, we'll make it less stable through more leverage, more risk taking."

Bingo. A Chinese family decides, what the heck, let's mortgage the house and invest the money in the Shanghai stock market. Prices can only go up! American bankers say, what the heck, let's lend people of dubious credit 100% on the price of a house. House prices can only go up!

But then another question is: Why must the corrections be so convulsive?

One of Mr. Scholes's favorite words is "model" -- as befits a man awarded a Nobel in 1997 for the famous Black-Scholes model for pricing stock options. In chaotic times, speculators (who are business

people, in Mr. Scholes's view, providing liquidity services to the market) doubt their models. They want to reassess. In today's ever more globalized and complex economy, "the information set is huge, it's gigantic." As a result, "decision time becomes elongated" and speculators hold back their capital just when their services are most in demand. The lack of liquidity itself then becomes a factor in asset pricing, leading to swift, sharp drops in values.

You may be tempted to slightly arch your eyebrows right now if you remember LTCM. Mr. Scholes expects as much. He's made his peace with it. He says he feels like the woman in the local paper who, whatever she does, will always be remembered for one thing: "Mrs. Jones, who was falsely accused of the ax murder of her husband in 1944, recently had a garden party for 10 of her friends."

Mr. Scholes, fellow Nobelist Robert Merton and former Salomon trader John Meriwether set up Long Term Capital in 1994. For the first three years, it delivered spectacular returns. Then came the Russian bond default of 1998 and other reverses, and suddenly the fund was deeply in a hole and, worse, its very large borrowings in danger of being yanked. Says Mr. Scholes succinctly: "The amount of risk taken by the fund was too large."

Was the financial system ever in danger from LTCM's collapse, as widely predicated in press accounts at the time? I half-expected Mr. Scholes to pooh-pooh the worry as apocalyptic. Instead he pauses, finally saying: "I don't know the answer. Obviously we had one run of history. It's interesting to me, however, that you could have taken the bankruptcy route and add that to the court system, and to think about what the consequences would have been."

We'll never know. A phone call was made. The New York Fed agreed to intervene and organize a notorious "bailout" by the creditors to prevent a fire-sale liquidation.

Mr. Scholes was doubly marked for notoriety because he had just a year earlier been awarded the Nobel Prize, along with Mr. Merton, for their work on derivatives pricing. He readily acknowledges that the episode was financially and personally embarrassing: "In life you pay tuition, right? Sometimes you pay too much tuition. Sometimes learning is costly."

That learning began in Timmons, Ontario in 1941, and young Mr. Scholes learned early about the risks of life. He was diagnosed with a progressive eye disease that would make reading difficult. It taught him to concentrate, he says, and to listen well. (He's been through three cornea transplants as an adult and now can see fine.)

Of an academic bent and inspired by the free-market insights of Milton Friedman and George Stigler, he ended up at the University of Chicago, albeit with the plan of returning to northern Ontario eventually, to help run a small chain of department stores (in towns with names like South Porcupine) that his mother had started and was now operated by an uncle. But then he and his uncle had a disagreement. "I was disowned," he says.

He needed a job but as a Canadian on a student visa, he wasn't legally entitled to work except on campus. Noticing a sign seeking a computer programmer at the campus computer center, he volunteered, though he knew nothing about computers. But as helper of faculty research projects, he became acquainted with faculty legends such as Lester Telser, Merton Miller and Gene Fama and discovered a fascination for securities markets, arbitrage and the pricing of risk.

Life next brought him to a teaching job at MIT, where he met one of his great collaborators, Fischer Black, who shares authorship of the Black-Scholes formula (though he died before the Nobel was awarded). Both men had been independently thinking about the knotty problem of how to price -- other than by intuition and experience -- option contracts. Though he says now he didn't understand what the

ability to disaggregate and price risks would really mean for the future, a financial revolution was in the making and Messrs. Scholes, Black, Merton and a handful of colleagues were at the center of it.

Businesses, he explains today, make their money from specializing in "idiosyncratic risk," not "generalized risk." Starbucks specializes in selling coffee to consumers. It doesn't gain anything from exposing itself to currency risk, commodity risk, interest-rate risk, etc. Greater sophistication in financial markets has now made it easier and cheaper to lay off these generalized risks to others more expert at managing them. Businesses can concentrate on managing the risks (and reaping the rewards) unique to their own skills and assets.

What does it all add up to? "I don't see derivatives or hedging of generalized risk as being unto itself. I see the cost of using those contracts as competing with the cost of equity. We'll see more substitution of risk management for equity."

Translation: The exit of companies from the public markets in favor of private equity will continue. And, yes, regulation is a factor too. "Maybe if we keep doing more and more regulation and rules, everything will end up in private entities, with risk transfer and hedging, and the corporation will disappear."

One point of attack on the public company, of course, has been executive compensation. Mr. Scholes hears his name invoked constantly, since the Black-Scholes formula has become the basis for assigning a value to stock options dished out to employees and senior management. He finds much of the criticism misguided, noting that executive compensation is a strategic matter for companies and no less subject to learning than other strategic considerations.

Many of the giant paydays that incense the media, he points out, came about because a company's share price, over a succession of years, greatly outperformed a board's reasonable expectations. As a board member, he says, "you might say the probability of the stock price going up 500 times is zero, so why do I have to write a contract" that protects the company from outsized payouts in such an unlikely circumstance? "But if that happens a few times, people will start writing" those protections into the contract. "So there's learning that occurs."

Ditto large severance payments for executives who were hired with manifest approval of the stock market and later fired when the shares underperformed. "People will fashion new contracts and new ways of doing things. Boards will learn. It doesn't mean you have to overturn the whole applecart simply because the market did terrific and a lot of people got paid well."

Back in the 1960s, Mr. Scholes was fascinated by the then-heterodox idea that markets are better at generating human welfare than government regulation. And he doesn't doubt that this megatrend is still unfolding -- witness the growing realization that governmental and corporate benevolence can't secure our old age, that we'll have to rely more on private planning and saving, and that a burgeoning advisory industry (already visible) will be able to help.

"That vision we had back in the '60s and '70s was that one-shoe-fits-all didn't work and wasn't working, and was constraining society as the world became more uncertain. More individualism and more flexibility would be needed. Is that a better world? Yes, in my view it's a better world."

Mr. Jenkins is a member of the editorial board of The Wall Street Journal. He writes a weekly column, "Business World," and edits OpinionJournal.com's daily Political Diary.

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