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Cheating

Ype Wijnia *26 October 2012*

In the last weeks, some remarkable stories made the news. The most controversial perhaps was the decision to strip Lance Armstrong of his seven victories in the tour de france because of the use of doping, in other words, cheating. To be honest I feel a bit ambiguous about that. First off all, naturally I agree that in any sport the best should win in a fair game. But on the other side it should be noted that cycling is not a fair sport, as the individual does not stand a chance against the peloton. It is not the sportsman who can cycle the fastest that wins, but the one that best profits from other cyclists that keep him under the lee. What about fair again? Furthermore, the yellow jerseys that were stripped off of Armstrong will not be awarded to someone else, as the full top ten of the tours in those years (give or take a few exceptions) has been connected with doping. See the table below based upon a table in NRC (a Dutch newspaper) of last tuesday. Only 3 cyclists have not (yet) been associated with doping. Apparently, everybody was cheating in those days. But if everybody was cheating, was it not a fair battle? Why then is it necessary to humiliate the grand master of cheating?

Most Pursuers of Armstrong also associated with doping
Cleared standings after Armstrongs disqualification
Associated w ith/ ever suspended for doping | Part of team w ith structural use of doping | Not (yet) associated w ith doping

1999	2000	2001	2002	2003	2004	2005
1 Alex Zülle	1 Jan Ullrich	1 Jan Ullrich	1 Joseba Beloki	1 Jan Ullrich	1 Andreas Klöden	1 Ivan Basso
2 Fernando Escartin	2 Joseba Beloki	2 Joseba Beloki	2 Raimondas Rumsas	2 Aleksadr Vinokoerov	2 Ivan Basso	2 Jan Ullrich
3 Laurent Defaux	3 Christophe Moreau	3 Andrei Kivilev	3 Santiago Botero	3 Tyler Hamilton	3 Jan Ullrich	3 Francisco Mancebo
4 Angel Casero	4 Roberto Heras	4 Igor Gonzalez	4 Igor Gonzalez	4 Haimar Zubeldia	4 José Azevedo	4 Aleksadr Vinokoerov
5 Abraham Olano	5 Richard Virenque	5 François Simon	5 José Azevedo	5 Iban Mayo	5 Francisco Mancebo	5 Levi Leipheimer
6 Danielle Nardello	6 Santiago Botero	6 Oscar Sevilla	6 Francisco Mancebo	6 Ivan Basso	6 Georg Totsching	6 Michael Rsmussen
7 Richard Virenque	7 Fernando Escartin	7 Santiago Botero	7 Levi Leipheimer	7 Christophe Moreau	7 Carlos Sastre	7 Cadel Evans

After NRC Handelsblad, Tuesday 23 October 2012

A second remarkable story was that of Jérôme Kerviel, a former trader of the French bank Société Generale who caused a great loss with high risk investments in derivatives end of 2007 / early 2008. In the appeal of the case the sentence was confirmed he had been given by court earlier. That sentence was 3 years of imprisonment and repayment of the caused losses. Again, I had some ambiguous feelings about this story.

On the one side it is hard to disagree with prosecuting bankers for the damage they cause by risky behavior. After all (and cutting corners), we have been in a worldwide economic crisis since 2008 because bankers would share the gain if they took a risk that worked out well, but did not share the pain if things did go wrong. After the Nick Leeson affaire of the Barings Bank one would expect the world of haute finance to have become a bit wiser, but that appeared to have been wishful thinking.

However, why then only imprisoning monsieur Kerviel? The losses he caused are nothing compared to the thousands of billions that evaporated later in 2008 in the big credit crunch. His claim that the bank knew what he was doing and allowed it as long as he was making a profit is not entirely unreliable. He only did things a bit bigger and had the bad luck of being caught. But he certainly was not the only cheat in the industry.

Besides, given the enormous amount of 4,9 billion Euro it is impossible to repay all. De representative of Société Generale admitted that they will not claim the full amount, but that they will account for future income in the payback settlement. But then the sentence is only symbolic, like sentencing somebody for 30000 years of imprisonment.

Both stories made me wonder whether cheating is possible in asset management. What is the asset management equivalent of doping? And what would be an asset management derivative? Nothing comes to mind easily. Doping is a means of improving the performance of the asset. In motorized sports examples can be found. In rallying, once a highly ingeniously constructed turbo compressor was used that could suck in more air than the was allowed. And in formula 1, things like minimum weight, fuel specifications, the use of traction control and many other regulations apply. Teams try to operate very near to the limits or sometimes cross them and then try to hide it. But that again is in the context of sports. If in the economic reality some manufacturer thinks of something that seriously boosts the performance of his assets that would be like striking gold, and not something that would be forbidden. On the contrary, we call that innovation and other manufacturers would try like crazy to realize a similar performance improvement. In that quest some patents might be violated which is also a form of cheating (think about the patent war between Apple and Samsung) but that has nothing to do with the technology itself, only with the question of who pays who?

With regard to derivatives, a similar lack of ideas occurs. In asset management there are real options. That is building in a facility (at a low cost) to be able to adapt to future changes (would they occur) at a relatively low cost, like strengthening the foundation of a bridge so that the deck can be expanded later on. But packaging derivatives (like the derivate to hedge against a drop in value of the reinsurance of the right to buy an option for a portfolio of common stock) seems to be difficult in real options. They tend to be more centered around the real asset. The most practical case of a real option is postponing maintenance because of high demand for the products the machine makes. If a drop in demand is expected soon this may be smart, stopping the machine in times with low demand is cheaper. But if that period of low demand does not happen the machine may fail because of the lack of maintenance, a problem the asset manager will not be able to hide with an exotic side letter.

Cheating I can imagine more easily is in selling assets. Thick about resetting the mileage of a car, a quick paint job to cover rotten, polishing a machine until it shines or advertising in general. Making an asset seem more attractive than it is helps in selling the asset at a price that is higher than its actual value. But this is only feasible if the asset is to be sold, and not if the asset is to be used.

Going even further brings us into the realm of fraud. Think about invoices that are sent for a maintenance job that was not performed, "processing" chemical waste that is just dumped in a river, or treatment plants through which the wastewater just flows without any treatment at all. But that is not asset management any more I would say.

Perhaps it is just my imagination failing, but to me it seems that the technical assets we are discussing simply do not allow for cheating. The laws they have to obey are essentially the laws of nature, and to my knowledge no one ever has been imprisoned for breaking them.

Ype Wijnia is partner at AssetResolutions BV, a company he co-founded with John de Croon. In turn, they give their vision on an aspect of asset management in a weekly column. The columns are published on the website of AssetResolutions, http://www.assetresolutions.nl/en/column