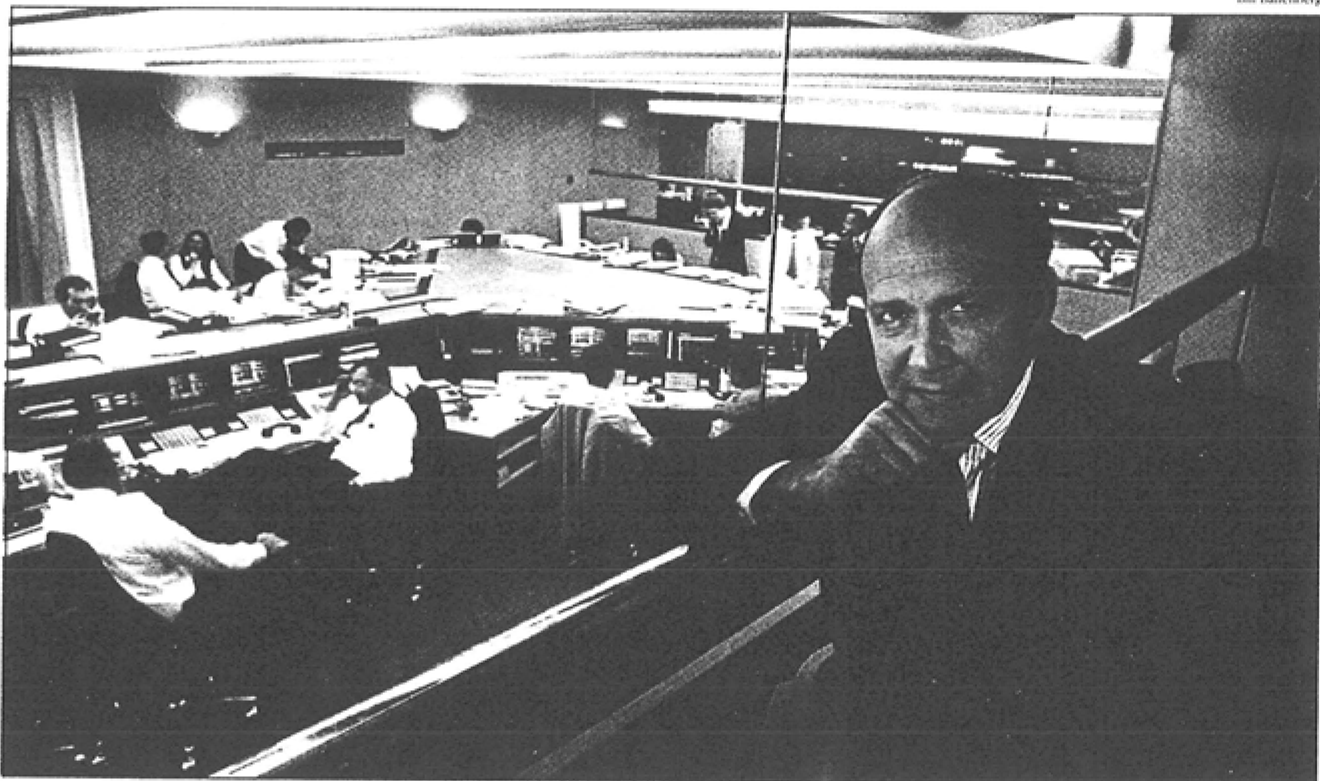
World Banker Eugene Rotberg overlooking the trading room
What is risk? Uncertainty, defined in terms of probability.

Bill Ballenberg



Some people think money management is an art, but at the World Bank Gene Rotberg and his crew practice it like a science.

Smart answers to dumb questions

By Ben Weberman

THE OLD EINSTEIN JOKE: In heaven the great scientist meets a chap with an IQ of 200. "Good," he replies, "I'll talk to you about my new theory of relativity." He meets another chap, IQ 140. "Ah," says Einstein, "we can talk about world politics and the chances for world peace." Third man has an IQ of 100. Turning to him, Einstein asks: "Where do you think interest rates will be a year from now?"

Eugene H. Rotberg feels a little like that. The man who manages $20 billion for the World Bank couldn't think of a dumber question than: Where do you think interest rates are headed? He always responds by asking a series of his own questions.

"Do you mean short-term or long-term rates? In which currency? Do you mean for a short period ahead or a long time or in between? At the beginning of the period or only at the end of the period? In between, will they go higher or lower? By how much?"

This 56-year-old former SEC lawyer needs to know all these things—and more. Under his direction the World Bank handles $5 trillion of transactions a year—not billion, trillion. The multinational development institution is known for its advanced interest rate forecasting techniques and for success in putting money to work. "We seek to predict interest rates for six different instruments and for five different time periods ranging from one day to five years at probabilities of 1-in-2, 1-in-4 and 1-in-10. We hold that security which has the greatest probability of giving us the highest rate of return with the least amount of risk. Conversely, we sell those securities that have the lowest potential return and the highest risk."

Risk, he says, is defined as "uncertainty—in probability terms."

Rotberg and his traders—they include seven Ph.D.s and numerous M.S.s in engineering, physics and math, in addition to the M.B.A.s most of them hold—engage in several strongly disciplined approaches to investment management. For them, how much a security cost is not a material consideration in judging whether to hold it. "Book cost is a past event. It tells nothing about whether we should hold a security or sell it," Rotberg says. Put another way, there is no such thing as

"hold" recommendation for the World Bankers. "If we own it, we would buy it—now. If its potential is mediocre, we sell it. If we buy a security at par and it trades at 105, and we sell it, and it later trades at 110, we made a mistake."

Each mistake is rigorously analyzed. "We record what we said should have been done, what we in fact did and what would have happened if we had made optimal decisions—in hindsight," Rotberg says. Most emphatically, however, the analyzing of mistakes is not done for purposes of reward or punishment.

Says Rotberg: "There are no rewards or punishments for superb or disastrous decision making. We believe that inhibits rational analysis. Our egos, our fears, our concern about jobs, capital and looking good have nothing to do with predicting interest rates. Therefore, to the extent possible, my responsibility is to relieve the staff from external constraints and let them concentrate on things that go into the political and economic decisions which are likely to affect interest rates."

There is no such thing as a "hold" recommendation for the World Bankers. "If we own it, we would buy it—now. If its potential is mediocre, we sell it," says Rotberg.

Rotberg is contemptuous of the way most commercial banks handle their investments. "The system that U.S. commercial banks have of maintaining portfolios at original book cost inhibits rational decision making. The portfolio manager is restrained from selling to cut losses because then the loss would be visible," Rotberg says.

The rigor of the analysis at the World Bank extends to insisting on counting the opportunity cost of money. "It is wrong to say you did not lose money if you held cash when bonds were paying 14% and they are now paying 7%, and you still have all your cash," Rotberg says.

That 14% bond you did not buy several years ago is selling now at 140, and you have lost 40% because you are still in cash.

Why does the World Bank maintain its $20 billion worth of liquidity? Why not lend it out, according to its charter, to developing countries? The bank believes that, for flexibility, a portfolio manager should have a generous cushion against the time when it may not be appropriate to borrow. "When bond markets deteriorate, we draw down our liquidity until markets stabilize," Rotberg says. "That gives us total flexibility as to when we borrow, where we borrow, at what maturity, whether at fixed or floating rates, in what currency, long or short, publicly or privately." The bank does not want to be in the position of having to borrow when it would prefer to wait six months.

"We've seen a lot of banks and corporations that assume the world is stable and predictable. They also assume that factors outside their control will never be harmful to them, that markets will always be there for them and for everyone else. They also assume that they can predict interest rates and exchange rates. They tend to borrow cautiously because they assume they can always get it later.

"They tend to borrow short rather than long, variable rather than fixed, because the immediate costs tend to be lower," he says. Rotberg and his associates think this emphasis on short-term costs is short-sighted and self-defeating.

In the financial markets around the world, Rotberg is held in awe. Overall he and his crew have been successful in helping the World Bank produce returns on earning assets (loans plus cash) that are far better than any of the U.S.' 15,000 commercial banks in recent years.

The rate of return on earning assets for the second half of 1985—first half of the World Bank's fiscal year—was 2%, about three times that of a commercial bank. The return on capital of 13% to 15% is about equal to large money center banks, although the World Bank has three times as much capital as a typical commercial bank.

Where do the profits go? In part to building reserves and in part for grants to poorer countries. "We have been able to minimize our charges to less developed countries because of the return on our own liquid portfolio and the low cost of our borrowings," Rotberg says.

And now for the dumb question: Whither interest rates? Rotberg says that on the basis of a current 7.35% return on 30-year Treasury bonds, the chances are 65-to-35 that rates will rise 100 basis points, to 8.35% a year from now, as against the possibility they will fall 100 basis points, to 6.35%. Explains Rotberg, "That means I feel twice as strongly that yields will be up by 1% rather than down 1%, and that is how I would arrange my portfolio." ■

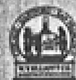
THE TEACHINGS OF TEACHERS

(One of William Teacher's favorites.)

NOTHING SO NEEDS REFORMING AS OTHER PEOPLE'S HABITS.

Mark Twain

And nothing so leads to divorce as acting on the above.



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