

Investment

Investing Must Fully Embrace Risk, Not Just Return

By: Bruce Curwood

Now seems like an especially opportune time for trustees, directors, investment committees, and plan sponsors to make significant and meaningful changes in how they manage risk. While I look at risk primarily from the perspective of Defined Benefit pension plans, much of what I discuss applies to other long-term funds such as endowments. We are still close enough to the scary moments of the market meltdown of 2008 and early 2009 to remember what that fear and pain felt like – and to want to do something so that we never experience those sensations again. At the same time, thanks to a relative strengthening in the markets since then, the ground appears solid enough to consider the bigger questions that proper risk management should entail.

This kind of searching exploration will reveal that risk is a complex beast. A framework is needed and, ideally, one that provides a practical approach and a comprehensive understanding for those who are accountable for meeting the fund's objectives.

Untangling The Complexity Of Risk

The starting point begins at the broadest level with a determination as to what level of risk the fund will take. This should be a wide-ranging exercise, rather than one about standard deviations from the norm. Appropriate governance must be established and there is a very strong connection between good risk management and good governance. Additionally, the objectives for the fund must be set and the asset-liability risk should be determined.

With the answers to these big questions in place, fiduciaries can begin to approach risk more systematically. I have created a guide that I call a 'General Hierarchy of Governing Fiduciary Concerns.' The reason for this name is that it is, after all, the governing fiduciaries, such as trustees or directors, who have the final responsibility. The hierarchy is just a starting point, however, as a good risk management approach must be customized for each plan. The magnitude and impact of the risks noted may change significantly based on each plan's objectives and specific circumstances.

The hierarchy identifies 57 different risks and ranks them by impact. The schematic groups these risks so that the governing fiduciaries can determine the most effective tools for managing them. They will have the key role in addressing and managing some of the risks, especially the larger ones involving governance decisions. For many of the other risks, they will have a supporting role and will delegate the actual implementation to staff and/or third-party providers.

As an example, the hierarchy defines legislative issues as a fiduciary risk with the potential for high impact and as one that is best addressed by good governance. Another of the 57 concerns listed on the hierarchy – derivatives – shows up as a moderate-level, structural risk that can be properly managed through asset class strategy decision-making. Of course, many risks, including derivatives, can at times take on overwhelming importance if circumstances combine the wrong way. For that reason, this hierarchy should, first of all, be taken only as a general guide. Secondly, risks that are shown as moderate or low should not be ignored, they can bite just as hard if they are overlooked.

Nothing Normal About Risk

The market crisis has taught us a great deal.

First and foremost, we quickly learned that investors were too often unaware of all the risks to which funds

were exposed. Making matters worse was the human tendency to be overconfident. Many placed too much faith in their risk management systems and in the protections they thought these offered.

Instead, quantitative risk management tools based on sophisticated mathematics have shown their limitations. Many 'black box' models begin with the assumption that asset returns are 'normal,' but the number of market crashes and crises in the past 100 years or so has far exceeded the number that would have been expected if returns were to come from a normal distribution. There is nothing normal about risk.

To move forward, we must acknowledge that risk is uncertain, complex, multi-dimensional and interdependent.

Although the grounds may be shifting, far too little time and too few resources are spent on risk management. While investment professionals say that risk and reward are equally important, in the same breath they would likely acknowledge that the preponderance of their time and effort is spent on efforts to generate returns.

For those looking to strengthen their risk management practices, the recommendation would be to install an approach that is fund-wide in scope, forward-looking, and clearly articulated. The risk management process must be multi-dimensional and incorporate both qualitative and quantitative perspectives. Finally, a risk management culture must be installed – one that is all-encompassing and considers the largest risks, alongside the smaller ones, frequently and consistently.

What does it mean to be fund-wide in scope? To qualify, the risk management approach must first identify and define all sources of risk. Next, the nature of these risks has to be understood and their potential impact measured. Then, risk management must assess which risks have been addressed and how. Finally, additional measures should be installed to manage the unaddressed risks and a continuous and systematic review and monitoring process must be put in place.

To be successful, the risk management approach must come together in a robust and vital fashion. Risk management must become a substantial part of the firm's culture. Transparency, communication, and a willingness to ask and address the tough questions all play their part. Investing must begin with risk considerations and not with simply pursuing returns. ■

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