MAKING RISK MANAGEMENT ACTUALLY WORK IN YOUR INVESTMENT OFFICE

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Let's face it. Investment returns get all the attention. They're the scorecard by which most investment programs get measured. Peer and benchmark comparisons are going nowhere soon. Likewise, those diamond-in-the-rough investment ideas are what every investor craves and wants to discuss.

Stepping back for a minute, how did your investment program generate its rate of return? At its core, your rate of return is produced by a collection of portfolio bets i.e., risks taken within your investment portfolio. Now, let's stop and think about what's being done to ensure those bets work in concert and as intended to produce desired outcomes, such as generating the level of return you desire or limiting losses. We call this risk management.

As CIO or CRO you may be thinking, "we've got that covered; we bought a risk system or we get reports". We hope you do in fact have that covered.

Having managed institutional portfolios ourselves and having worked with institutional investors who care deeply about managing risks, we'd like to share three common pitfalls of investment risk management:

Risk management that is limited to reporting only. Too often investment risk management is limited to a reporting function. Reporting may be an initial step in attempting to practice risk management or may be done merely to satisfy compliance requirements. Whatever the situation, reporting-only approaches to risk management may start to feel routine or burdensome and then often fade in importance, relevance, and impact over time.

Risk management that is an off-the-shelf system. Organizations that have purchased a system have embraced the value of risk management to some degree, since budget dollars have been committed. Usually, there are systems or technological tools employed as part of any comprehensive risk efforts. However, too often we see procurement of systems that are ill-suited. These may be systems that are really designed for money managers' daily operations and trading, rather than the needs of asset owners. Many of these systems don't relate at all to the investment objectives of asset owners, which tend to be strategic in nature. Such systems often use statistical definitions of risk that may or may not matter to the asset owner. Or, systems only cover certain assets such as public equities, ignoring important parts of the portfolio such as private assets and alternative investments. Finally, many off-the-shelf systems may narrowly and often unrealistically, define market behavior according to normal distributional assumptions i.e., failing to account for the potential for large drawdowns or sequential declines in value. Ultimately, risk management is a practice exending beyond even the best-suited system, since risk management is not just the system itself.

Risk management that is disconnected from portfolio management. For any number of reasons, risk management information is not fully used by investment officers. For example, the information itself may not be actionable or there may be lack of buy-in. In these situations, there's no application of potentially valuable (yes, return generating) information. What might be great information about risk exposures and how the portfolio's bets are placed is not utilized. Assuming organizational buy-in, risk management information must also be identified as valuable and actionable. Otherwise, the impact is lost.

Nearly every investment officer with whom we speak nods in agreement with the maxim that how they allocate their investments (or allocate their risks, or place their bets, or whatever terminology one wishes to use) substantially determines their results. The opportunity for investment offices to put risk management to work is great. That means integrating risk management with portfolio decisisons such as allocating cashflows, adding investment strategies, etc. The results are ultimately in the returns. We all need to be mindful to avoid the common pitfalls that differentiate successful risk management programs from those that are not.

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