

OPINION

Risk management: head winds and tail winds

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Over the last decade I have been a major proponent of institutional investment funds (pensions, endowments, insurance etc.) analyzing their strategies and their risks in a more comprehensive and systematic fashion through enterprise risk management or ERM. Having read countless books and articles on the topic of risk management, it's encouraging to see greater dialogue on the topic in the industry, but it's also a bit exasperating to see so little action by investment funds (apart from the mega funds)!

True, it must be recognized that ERM is a newly evolving field, still in its infancy, and that the demands on investment committee time are increasing. That said, it seems quite obvious that conventional approaches to investment management haven't worked well and seem to be failing us in the new normal—this new market environment of greater austerity, lower returns and higher volatility. Exhibit 1, put forth by Funston and Wagner, demonstrates some of the problems conventional wisdom faces in an unconventional reality. In fact, as shown by the latest \$2.3 billion "rogue trader" loss at UBS, we don't even seem to learn from recent past errors (Soc Gen—Kerviel, Barings—Leeson, etc.), where conventional wisdom should ensure compliance. The crux of the problem is the inequitable amount of time and resources that investors spend on return over risk. To remedy this requires an overhaul of the approach to risk management, and building an organization-wide risk management framework and culture, or ERM.

Exhibit 1: Correlation matrix:
"Surviving and Thriving in Uncertainty: Creating the Risk Intelligent Enterprise,"
by Frederick Funston & Stephen Wagner, 2010, John Wiley & Sons Inc, p34

CONVENTIONAL WISDOM A random walk	UNCONVENTIONAL REALITIES Random, with hops, skips and jumps
Factors affecting events will remain equal	Factors affecting events will change
Events are mildly random	Events can be wildly random
Extreme events are rare and should be treated as anomalies	Extreme events are more common than we think and should be treated as such
Forecasts are accurate and reliable	Forecasts are inaccurate and unreliable
Events are independent of one another	Events interact
Markets are efficient and rational	Markets are neither efficient nor rational

OPINION (continued)

Perhaps plan sponsors and investment committees alike have failed to grasp the potential implications of this new normal, due to overconfidence, denial or pre-existing bias. Nevertheless, let's examine the facts (see Exhibit 2). From 1981 to 2007 world equity markets were fueled by a series of inter-related, positive events that are probably now in the process of reversing. For example, there were several strong tail winds to market growth:

- > inflation and interest rates steadily descended from their lofty heights of the early 1980's;
- > the de-regulation of investment markets, fostered a plethora of new and often complex investment vehicles (collateralized

debt obligations, asset backed commercial paper and various derivatives), which lubricated the debt markets;

- > as consumer and government debt levels were at reasonable levels, these sectors expanded their purchases and borrowing capacity, often through leverage;
- > global trade expanded by leaps and bounds and was further aided by the end of the Cold War and cheap energy (world oil prices well below \$40 a barrel).

No doubt there were market setbacks throughout this era, but the overlying trend was upward and positive, interrupted only briefly by short and sometimes dramatic downturns.

Exhibit 2: Market tail winds and possible future head winds

1981–2007 tail winds	2008–2020 future head winds?
Interest rates steadily fall from 1981 peaks	Short term interest rates are near all time lows and should rise
De-regulation of investment markets	Global financial crisis, fraud and various market abuses may lead to greater regulation
Globalization of trade as Berlin Wall falls and Cold War ends > cheap energy	Possible protectionism and tariffs? > expensive energy > regionalism?
Consumer and government debt levels reasonable	Consumer and government debt levels (debt/GDP) elevated
Leverage	De-leveraging
Falling inflation	Greater uncertainty as politics may lead to dichotomous outcomes (inflation or taxation)

Source: Russell Investments

The global economy is a complex, nonlinear system that is turbulent and near impossible to predict. Looking forward, none of these positives (tail winds) are likely to continue as the proverbial head winds take hold. With governments printing money or devaluing their currencies to keep economies liquid and afloat, it's only a matter of time before inflation starts to rise and interest rates bounce off their record lows. Heavily indebted nations (Portugal, Ireland, Italy, Greece and Spain—the PIIGS) are already feeling the pain of higher borrowing costs. Following the banking frauds and various market abuses during the global financial crisis, a plethora of new regulation has been legislated (Dodd-Franks, etc.) or is imminent in a host of countries. However, regulating a complex, tightly coupled system may worsen the problem rather than solve it. Government and consumer debt levels are now at shocking levels and threaten world economic growth. As for oil prices, they have indeed fallen from their peak (\$150 bbl to near \$80 bbl), but are

still twice as expensive as they were in the recent past. Growth in the developing world (Brazil, India, Russia and China—BRIC) and their thirst for energy and resources is not likely to abate. So too, is there a finite supply of oil with limited substitutes, as solar and wind make up less than 5% of the energy grid. The sum of all these events is that the current picture for world markets is far less rosy than we have previously known and that investors face some strong head winds for an extended period of time.

In short, the rewards for effective risk management are greater than ever. It's time for institutional investors to acknowledge the problem and take action now. This is indeed the perfect time to talk risk management because the memory of the roller coaster that was the global financial crisis is fresh, yet markets have recovered significantly from their March 2009 lows. Perhaps investment committees can now turn these potential market head winds into risk management tail winds! 🌪️

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