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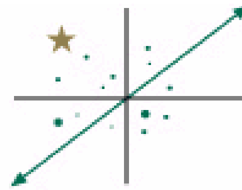

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Naming Names: Coming to Terms with Risk

What's in a name? When it comes to risk, quite a bit.

Psychologists tell us that our worst fears tend to be the ones we cannot name. The first step to overcoming a fear is to identify it, so you can begin the process of understanding it and controlling.

The same holds true with risk. If we don't define it, we become vulnerable to a vague fear that events are spinning out of our control. Especially in times like the present when markets are volatile and the world is full of turmoil, we may want to flee "risk" for "safety". That's a natural reaction, but acting on an emotional impulse may be hazardous to one's long-term investment strategy.

After all, every investment carries some kind of risk. Even converting all our assets to cash would carry risks. First, there would be the risk that inflation would make our cash diminish in value. Second and equally important, there would be the risk that, over time, we would not reach our investment objectives.

Experienced investors know there are many types of risk, each with a specific risk management technique. By taking a systematic approach to investment risk - breaking it down into the types of risk that affect our individual portfolios, we can begin to take control of our financial future – and breathe easier when the market is volatile.

For most plans, a strategic investment strategy should not seek to eliminate risk altogether. It should seek to manage risk, so that investment portfolios are structured to meet investment goals, within your plan's tolerance for risk.

Asset-Class Risks and How to Manage Them

Every asset class has risks specific to it. Stock portfolios, for example, are capable of providing substantial returns over time, but they are also subject to volatility and market risk – the risk that an overall market downturn will drive down the current price of your portfolio in a similar manner.

Bonds and other fixed income securities are prone to interest rate risk: the risk that market interest rates may rise, which directly manifests itself through a drop in the current value of outstanding bonds. Most bond portfolios are also subject to some form of collection, or credit, risk.

Cash instruments – including Treasury bills of six-month maturity or less, bank deposits, money market funds, and other short-term fixed income instruments – are all prone to inflation risk. Even real estate, which many investors have found to be a refuge in recent years, lacks liquidity and is subject to boom and bust cycles.

One of the best ways to manage these risks is through diversification. As economists Harry Markowitz and William Sharpe demonstrated in their Nobel Prize-winning work on portfolio theory, a diversified portfolio can accommodate a certain amount of "risky" investments, which in turn may actually produce higher potential returns with lower potential risk than a portfolio that attempts to avoid risk altogether.

Although past performance doesn't really give us much help in predicting the future, history does supports the wisdom of diversification – both from a risk and a reward perspective.

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Company-Specific Risk

Events during the early part of this decade reintroduced a risk that many investors had forgotten during the bull market of the 90's: management integrity. The quality – or abuse – of corporate accounting standards took center stage, as many investors began to feel they could no longer take for granted the accuracy of the audited records of public companies. These fears led investors to again take a much more in depth look at the actions of corporate boards and management teams – suddenly company-specific risks were everywhere!

While this is clearly a legitimate concern, particularly because of its all-too-frequent occurrence, the risk itself is manageable. To maximize their awareness of the issues, and in the process minimize company-specific risk, investors can seek professional money managers who are firmly rooted in fundamental research. Investment management firms that perform their own research, unencumbered and un-conflicted by banking or advisory relationships, are in the best position to sniff out and avoid trouble at companies.

And, once again, diversification is an investor's best friend. All manner of company-specific risks, and their potential impact on portfolio values, can be mitigated by limiting a portfolio's holdings in any one company or industry sector. Conversely, highly concentrated portfolios produced by quantitative black box approaches are unlikely to minimize company-specific risks.

Behavioral Risk

One of the biggest risks of investing is not "out there" in the market; it is inside us. Human behavior can cause us to panic, or do things that feel right in the short term, but in the long term are unwise. Behavioral risk often goes unrecognized because investors tend to miscalculate their sensitivity to market swings. For example, most investors will overstate their tolerance for various risks during a boom market, and understate their tolerance during a bear market. This is why your investment strategy should be constructed and regularly revisited with a disciplined, objective approach.

Your time frames for meeting particular goals should also be geared to the realities of the market, not merely the best potential outcome. For example, if your DB plan is facing a rather large current funding gap, are you really in a position to consider an aggressive investment approach that may allow you to close the gap in the next few years – but might also result in a meaningful expansion of the gap? Does your organization have the resources to deal with the latter situation if forced to? The current interest in liability-derived investment strategies, which offer to close such gaps very slowly (but surely), suggests to us that many plans have already asked and answered these questions.

A related situation is apparent in the endowment and foundation communities. Spending programs were ramped up well in excess of inflationary pressures in the late 90's, as organizations largely spent the period's out-sized 20% annual returns and *still* grew assets at the rate of inflation. Losses in 2000-02 left many of these groups in the difficult position of needing to sharply downsize current program spending in order for asset growth to "catch-up" in real terms. Today, an aggressive investment approach might solve both short-term needs, but only if it produces returns consistently above inflation rates. Thus, the search for investments "certain" to deliver *consistently high real returns*, has intensified to a fever pitch. In turn, this process presents its own set of risks – behavioral and otherwise.

Conclusion

The first step in coming to terms with the variables of investments - the risks - is identifying and defining those risks which most concern us and our plan. Not one Greek letter is needed to do this. Measurement of those risks should come later, once we've determined what it is we are truly seeking to control. By narrowing the focus, we are then in a better position to gauge our exposure to various future scenarios. In turn, this helps us construct an investment plan with which we are comfortable.

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