STANDARD DEVIATIONS

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From Asset Classes to Risk Buckets - *Is your benchmark misbehaving?*

By William G. Ferrell

Executive Summary

In the following article Bill Ferrell shares his thoughts on the differences between asset management and risk management and shows how risk allocation is increasingly the difference between mediocre and superior results.

Taking equity risk off the table in favor of absolute return strategies has been our recommendation since equity market volatility reached a 45-year low at the end of 2006. Dubbed "Risk Dieting," this approach forces investors to look at investment portfolios through a new set of goggles — the kind you want to wear when the water is as murky as the markets have been lately. Understanding the concept of the Risk Diet forces investors to think differently about how they allocate their investment resources.

We are not suggesting a new asset class. Hedge funds that drive absolute return strategies do not qualify as an asset class. Hedge funds are a discrete management methodology of owning both long and short positions at the same time in a broad range of asset classes and markets. The diverse investment styles in global equities, fixed income, currencies and commodities allow experienced investment managers to construct portfolios of hedge funds manageable to target risk levels.

When one invests in equities, it is nearly impossible to gauge the volatility of risk itself when you invest in equities. One minute the market is trading with limited price variance (volatility) and then suddenly the same stocks are all over the map - as they have been over the course of the past month.

Mohamed El-Erian, president and chief executive of the Harvard Management Company which manages the $29.2 billion Harvard University endowment, recently said, "(We may be) entering a world where more sophisticated risk management capabilities will increasingly be the main differentiator." (Financial Times, July 26th, 2007).

So what does all this mean? What's the difference between asset management and risk management? Let's look at the differences listed below:

Asset management	Risk management
Is about "how many" of each investment to buy and hold.	Is about the volatility and correlation of investment strategies.
Differentiates by the contents of the investment.	Differentiates by how each investment behaves.
Is passive to changing market conditions; allocations are to asset classes whose risk levels routinely change and cannot be controlled.	Expects market conditions to change and adjusts proactively to control the range of performance outcomes.
Often tied to traditional, politically correct constraints to stocks and bonds; performance varies greatly by cycle.	Focuses on investment growth and compounding; performance of the best risk diversifiers is both higher and less variable.
Is about investment performance comparable to benchmarks.	Is about making positive investment returns most of the time, regardless of traditional benchmarks.
Faith in benchmark.	Faith in diversification and active management.

Officials at the UConn Foundation are moving towards a more “risk-focused” allocation process to help lift performance. Their goal is a wise one for all investors: minimize the range of investment performance outcomes (that is, lower performance volatility) and maximize the return. The way to do this is to measure all investments through risk goggles and allocate the best sources of risk-adjusted returns. The allocation of real dollars (assets) comes after the risks are determined and allocated.

The difference in managing an asset allocated portfolio vs. a risk allocated portfolio is enormous. Asset management is inherently slow to respond to performance shifts. As long as performance is in line with benchmark and peer group results, portfolios stay put. They count on the asset classes eventually producing positive results. If the S&P is down 8% and the portfolio is only down 6%, asset allocators do not question the efficacy of misbehaving benchmarks the way risk managers would. Risk management responds to changes in the two primary components of risk: volatility and co-variance — coupled with an insatiable appetite for information that may lead to new diversification opportunities.

Risk managers focus on tracking changes in the volatility levels and correlations of their investments. Mr. El-Erian wrote, “An interesting decoupling phenomenon has been in play over the past few months,” which is the same change in correlation that makes portfolio risk change. Risk allocation forces investors to broaden the diversification of the whole portfolio to include more investment categories. Finding non-correlating investment opportunities with high risk-adjusted returns is a good start. The best risk allocators examine the volatility of correlation and the volatility of volatility. Markets with wide ranges of historical volatility (like public equities that vary from 7% to 25% standard deviation and average 15%) are reliably unreliable from time to time. The key is to allocate risk to investment strategies likely to continue to add diversification value and attractive risk-adjusted returns.

In the world of risk management, investment performance is measured on a risk-adjusted basis. Relative value of each strategy is determined by measuring the marginal impact of each investment on the whole portfolio. The process is complex and requires a great deal of both math and judgment. At the end of the day, Modern Portfolio Theory works. Harvard’s 10-year performance outpaces the averages for large pensions, endowments and foundations by nearly 6% per year. Risk allocation and management improves investment performance and, as Mr. El-Erian points out, “will increasingly be the main differentiation between mediocre and superior results.” ▪

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