Managing Risk and Expectations

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The topic of risk management is very broad, and a myriad of discussion points come to mind when one ponders on it.

Investing money in both traditional and alternative assets comes with uncertainty regarding the range of outcomes. Equity investors often worry about whether the companies they are invested in will deliver earnings and live up to their assessment of intrinsic value, while bond investors concern themselves with the borrower's ability to service the coupon payment and pay back the initial investment at the end of the bond's tenure – this is just one way of looking at risk. At STANLIB Multi-Manager, one of the ways we view risk is from our clients' perspective, and we concern ourselves with delivering outcomes that are either in line with or exceed our clients' expectations. Our clients come to us looking for solutions that give them exposure to various asset classes (whether its equities, property or fixed income) or target a specific outcome or goal, and each of these has inherent risks associated with it. In the next two sections we will explore how we look at risks in the portfolios we construct for our clients and the measures we take to mitigate them.

Risk from a client's perspective

Our starting point is to try and understand the client's return objective, and his/her tolerance and ability to take risk. For most clients, the objective is often to outperform a certain benchmark or market index – this could be the JSE All Bond Index (ALBI) in the case of South African (SA) bonds or the FTSE/JSE Shareholder Weighted Index (SWIX) in the case of South African equities. By definition, to outperform, one has to deviate from the benchmark and this deviation gives rise to both absolute and active risks to a client's portfolio.

Active risks can be measured by active share or tracking error (the former being an ex-ante measure and the latter being an ex-post measure). If you can identify and measure the risks, then they become possible to manage. In this article we will highlight a few of the absolute and active risk metrics we look at, but these are by no means all that we consider.

Absolute risks are the risks inherent in specific asset classes and can be proxied with metrics like volatility – a measure of the uncertainty or dispersion of a portfolio's return; or maximum drawdown – which measures the maximum loss from peak to trough during the life of an investment. All proxies of risk have inherent weaknesses, and the two listed above are no different. They both share one weakness, which is that they are backwards looking, relying on historical returns, which may or may not have a bearing on future risk or uncertainty of future returns. They do however provide insights into the reality of the past, and we can decide how this could be extrapolated into future expectations. We design portfolios aiming to have lower absolute risks than the asset classes they invest in.

However, what's more important to us is active risk, and the metrics that measure it, as this will represent the risk of not meeting our clients objectives. As stated previously, in trying to outperform client selected benchmarks, one has to take some active risk, and both the portfolio manager and the client need to understand this. The amount of active risk taken, depends on the outperformance sought, but one needs to be very careful when interpreting this as higher tracking errors (a measure of active risk) do not necessarily imply better prospective returns i.e. active risk is a necessary but not a sufficient condition for outperformance. Very often, high tracking errors result in underperformance, sometimes substantial underperformance.

We therefore contemplate a client's active risk tolerance in addition to their outperformance objective before designing an appropriate portfolio, to ensure we deliver excellent risk-adjusted returns. The information ratio – a risk-adjusted return measure – is one of the metrics that provides an indication of how well this has been achieved.

How do we mitigate these risks while continuing to keep the client promise?

As a business that invests with various asset managers, it is absolutely imperative for us that we develop an in-depth understanding of the various South African (and global) investment houses. Our team spends countless hours researching asset managers and assessing them both qualitatively and quantitatively on their various capabilities. This assessment gives us a good understanding of the manager's investment philosophy, process and people, and how this all works together in delivering past performance. It also helps us in understanding how managers have fared over different market environments, or other dimensions that distinguish manager performance i.e. how they and the portfolios they manage behave when different things are happening in local and global capital markets. All of this information and understanding assists us in forming our views on how these managers are likely to perform in future, and what role they may play in our portfolios.

Kamini Moodley, our Head of Manager Research, explores more of this in her article on how we assess asset managers from a risk point of view. Equally important to us is understanding various asset classes, their macro-economic drivers and alpha opportunities. Our knowledge of asset managers and asset classes allows us to take advantage of what is often referred to as the only free lunch in investments, diversification.

In the first quarter 2016 Mindset we covered the importance of diversification across investment houses and investment styles at length so I will not dwell on this here. Another important risk mitigating lever is to have access to relevant technology.

At STANLIB Multi-Manager we have the privilege of having access to both off the shelf systems like Bloomberg, I-NET, Morningstar and IMaps, as well as our own proprietary systems. These systems allow us to identify, measure, mitigate and monitor various risks that our client portfolios are exposed to, both on an ex-ante basis (using up to date portfolio holdings/ positions), and on an ex-post basis (to understand and explain past performance and risk taken).

The views and measures we have highlighted so far give us a platform to construct portfolios that can deliver on our client's expectations, but our efforts do not end there. Post this phase, ongoing portfolio management and portfolio review becomes crucial. We continually review our portfolios relative to their guidelines to ensure that we continue to deliver outcomes that are consistent with our client's return and risk expectations. Our portfolio review process forces us to constantly review our assumptions and conclusions.

Finally, the vast experience of our team, who have seen various market cycles and know the managers and their people really well, help us position our portfolios to take advantage of return opportunities without taking undesirable risks. It also helps ensure that investment ideas are exhaustively debated before they find their way into our portfolios. These efforts help us mitigate most of the unwanted risks that our client portfolios would otherwise be exposed to.

In conclusion

We understand that there are many ways of looking at risks and taking the client's perspective is only one of them. However, as individuals who take huge pride and responsibility in managing money on behalf of a large portion of the South African investing community, we feel that it is critical to focus on risk from our clients' perspective. In conducting portfolio risk management, we think that it is imperative to consider both ex-ante and ex-post risk metrics as proxies for the actual risks faced by portfolios in attempting to outperform their benchmarks.

In this article, we highlighted some of the risk metrics we consider – however, we did not cover all of them and by no means do we claim that the ones we have not mentioned here are of any less importance. Notwithstanding the effectiveness of some of these metrics, we caution that portfolio managers and clients need to understand the limitations that accompany any risk proxies or metrics.

Finally, in trying to mitigate many of the risks our portfolios face, we rely heavily on our insight into asset managers and how they think about capital markets and their portfolios, as they are an important defence in the risk management framework. We also rely on our market knowledge, team experience and debate, and smart use of technology to help us carry out this task with due care and diligence.

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