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Risk Evaluation Within Asset Management: A Practical Perspective

By Peter Branner

This is an article in a Brandes Institute series addressing the question, "What is risk?" This article was written by Brandes Institute Advisory Board member Peter Branner. The author has been involved in investment management for over 20 years and is currently the global head of investment management for a substantial European financial institution. This article represents his perspective on a number of risk factors that are sometimes overlooked or underestimated.

During the last 20 years we have seen a gradual move toward mark-to-market accounting, relative performance evaluation and quantitative risk measures. In this article I attempt to explain why we have seen some of these developments, and how they may have been precursors to the 2008 financial crisis. To balance out the negative points, I have added some comments designed to provide helpful yet less obvious ways to evaluate asset management risk. In particular, I focus on the following seven aspects of risk in investment portfolios:

1. The impact of mark-to-market principles may push investors toward decisions that may not make sense from an investment perspective.

2. The emphasis on relative performance evaluation has led many investors to be complacent about the underlying risks in their portfolios.

3. Even those who sought absolute return strategies have found there is no "free lunch."

4. Organizational risk among investment managers is endemic. From misalignment of manager and client interests at larger firms, to capital adequacy risk at smaller boutiques, this is an area that can undermine even the most successful investment strategies.

5. Cost risk, the possibility that fees are so high that investors' goals require an unattainable gross performance, is often forgotten; in a low-return environment, it becomes much more visible.

6. Benchmark risk is intriguing: as more investors try to match a benchmark, the task may become harder. Investors also need to remember that it is more important to pick the right benchmark than to match exactly the one they've selected.

7. Style risk is often the dominant component in performance attribution and short-term underperformance risk is especially prevalent for value strategies. While any approach can be expected to have periods of underperformance, value portfolios may have more stocks that go in or near to bankruptcy. Diversification is the key.

1. THE IMPACT OF CHANGED ACCOUNTING PRINCIPLES

Recent developments have revealed the dangers of mark-to-market principles. Apart from the negative spiral that forced selling can trigger, there are other important implications related to the ever-increasing herd mentality in financial markets.

My original view on risk management within asset management stems from risk valuation in bond portfolios. Early in my career, I managed portfolios where valuations were based on the lower of purchase or market price. The effect of this accounting principle was that these large bond portfolios were able to maintain a relatively high duration profile (because most issues were purchased well below par and were generally held until maturity). As the portfolio typically held most of its securities for an extended period, these holdings generally had moved higher in price over time.

As a result, potential negative effects of interest rate fluctuations would only hit the accounts in extreme cases, i.e., if there were a dramatic increase in interest rates, and even that would impact only a limited portion of the total portfolio. Simultaneously, the principles meant that we were able to exert some “smoothing” control over the annual net reported result of the enterprise by selling securities with large unrealised gains just prior to year-end.

This accounting method obviously did not change the fact that we experienced large swings in the unrealised gains in the portfolios, but these effects were not reflected in the public accounts. Consequently we were able to offset other fluctuations in the accounts by working actively with the realised and unrealised gains in the bond portfolio. For our shareholders this meant a fairly smooth development in the reported results, and the fact that the unrealised losses sometimes could be substantial compared to the net result did not seem to bother them. Not that we had anything to hide, but it undoubtedly gave management more freedom to act upon investment- and other capital-related decisions in order to meet our long-term goals.

All this changed a few years later once the enterprise changed status to become a listed bank on the stock exchange. From one day to the next the accounts fluctuated and the bond portfolio was marked to market. The ensuing impact on our view on duration risk was dramatic; the direct consequence was a substantial reduction in the portfolio duration from several years to just a few months. In the early 1990s, we had inverse yield curves in Europe and initially the duration reduction actually seemed like a benefit, but this changed gradually as the yield curve normalized, reducing the longer-term interest margin.

My observation is that accounting principles had an enormous influence on how my colleagues and I evaluated risk despite the fact that the risk characteristics of the underlying bond investments were virtually unchanged. In hindsight, it is remarkable how the shift from purchase principles to mark-to-market accounting not only changed our way of looking at the risk involved in bond investments, it furthermore forced us to change the way we viewed existing bond investments and eventually caused significant changes in the portfolio construction and overall allocation to risk. Given the immediate impact of "mark-to-market" valuation changes on the bank's financial statements, many significant investment decisions were substantially more influenced by the bank's Board of Directors rather than the investment management team. Given that the Board typically had much less investment experience than their professional managers, this did not generally have positive results.

I have since seen similar situations in both equity and real estate investments. Particularly within real estate, the levels of liquidity and transparency often give the asset manager a large degree of freedom to influence the actual reported performance when there are sizeable unrealised gains in a portfolio.

Whether one principle is better than the other depends on many factors, but in a situation with panic driving rapidly falling asset prices we have now seen the negative side of mark-to-market accounting: contributing to an escalating downward price spiral as deleveraging continues.

2. COMPETITOR RISK – THE PITFALLS OF RELATIVE PERFORMANCE EVALUATION

Transparency ("if you can measure it, you can manage it") has been a key concept during the last two decades. However, good governance and the demand for increased competition actually have led to a suboptimal use of relative performance evaluation. Good intentions have inadvertently caused behaviour which can reinforce the momentum of market panics.

In the late 1990s I began to work more systematically with manager selection and monitoring and it became clear to me that most asset managers and institutional investors within both bond and equity disciplines were obsessed with relative performance and peer group comparison. It was also in these years that the influence of rating agencies started to increase and they had a reinforcing impact on the relative performance crusade. The big advantage with relative performance was that management of these investment firms had found a great performance measurement tool for their products and, in particular, the investment staff. This led to the use of transparent (i.e., measurable) but dangerous bonus systems that generally pushed investment staff toward a 1-year investment horizon. Investors, both private and institutional, found the same joy in transparency and third-party asset managers were sometimes able to change their benchmark if their relative performance no longer looked attractive in requests for proposals (RFPs). Consultants seemed

quite content as well. The relative performance tool allowed observation of relative risk, style consistency and many other "interesting" measures, making it possible to rank asset managers and thus aim to add value in the selection process. Everybody was happy.

My observation was that the gradual move from absolute to relative performance measures had an enormous influence on how we all perceived risk. Most remarkable were periods of severe absolute losses, when institutional investors were jubilant that they only lost 7% (for example) when the market was down 9%. At the time it did not seem to bother anybody, particularly as most performance downturns were relatively mild. However, as we see the present financial crisis deepening, it is obvious today why absolute performance should be a key requirement for those investors who are going to survive.

3. HEDGE FUND RISK: IT SEEMS THERE IS NO FREE LUNCH!

As most moved toward relative performance measures, some investors avoided the "relative performance trap" and targeted absolute returns. Given that some of the more astute asset managers were looking for ways to increase fees, the two groups found an ideal tango in the hedge fund bonanza that flourished during the final stage of the bull market in the past decade. After the bursting of the information technology (IT) bubble, investors seemed willing to pay anything for the promise of double-digit returns. With cheap funding and abundant leverage, there was a rush to hedge funds. Apart from several serious compliance blow-ups, the hedge fund industry seemed to have superseded many of the conventional asset managers who had been around for years. Many of the ones that remained suffered from deteriorating assets under management (AUM), shrinking fees and – most importantly – brain drain, as professionals left to start or join hedge funds.

However, I recall many investors claiming that hedge funds came without risk – because smart asset managers had hedged it away. I was sceptical about hedge funds in those years – but most investors seemed to care less. Admittedly, for a long time, my critique appeared wrong owing to low volatility, free access to cash, and little to no concern about the fact that fees were excessive – as long as the performance looked good. We've now learned that there is no "free lunch," even in hedge funds.

4. ORGANIZATIONAL RISK – COMPLEX YET IMPORTANT

During due diligence meetings with asset managers I always enjoyed most the part about people and organizations. Partly this was because the search for talent is by far the most important part of the selection process. Partly it was because this area offers unlimited possibilities of being impressed, excited and perhaps even seduced (at least intellectually). Incorrect assessment of organizational risk is probably the biggest risk within asset management. It is also the most difficult to quantify.

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Most asset managers are quite intelligent, well-educated, eloquent and better compensated than key staff in most other industries. The latter fact does not always attract people with a genuine interest in doing well for the ultimate investor, but often draws marketers motivated by selfish interests of making a quick fortune.

My observation is that large asset management firms often have difficulty in retaining talented and experienced investment professionals. In recent years this problem has been amplified by the tempting offers from private equity firms and hedge funds, which have generally been able to offer much more attractive ownership and bonus structures.

At the same time many large asset management firms have a very short investment horizon (typically one year) due to the misunderstood need to align the calendar year with bonus payments to the investment staff. In combination with the focus on relative performance, individuals with longer investment horizons, such as value investors, tend not to flourish in such an environment. Depending on their ownership and reporting structure, a number of these investment firms also may have a tendency to override decisions made by investment professionals in periods of underperformance. Investment managers with a good long-term performance track record typically will experience periods of really bad performance that may last up to three or four years[1]. Naturally, such a vote of no-confidence in the staff will have an impact on the morale and subsequent retention of quality investment professionals. This is an important risk that investors should understand, impacting the stability and involvement of senior investment professionals managing the investment process.

The last, but not least, people-related risk factor is career risk. Similar to the obsession with relative performance, the focus on competitors can lead to some unfortunate decisions regarding risk levels. In particular, investors need to be aware during the last month of an investment year. First, the manager may have a tendency to reduce his/her "bonus risk" if the rest of the year has shown very positive relative performance. Alternatively, the manager might try to take more risks in a mediocre or poor relative performance year to increase the chances of getting a good bonus. This is why a deep understanding of the manager's compensation structure is essential. Generally, as an investing client, I prefer to see a combination of annual, long-term lock-in schemes and an equity-ownership plan, either real or phantom. It is of utmost importance that there should be alignment of interests between the investor and asset manager. For very large (typically publicly owned) financial firms, this may still not be enough. In such organizations you even need to look at top management compensation and goals. Such goals often are related to the financial year and

[1] "Death, Taxes, and Short-Term Underperformance: Non-U.S. Mutual Funds." The Brandes Institute. July 2007. www.brandes.com/institute

consequently not ideal for a client with a longer investment horizon. An investor cannot do much about this apart from trying to understand the level of autonomy the asset management group possesses. Even this is not always enough as that autonomy can be compromised following a period of weak performance.

More often than not, it is impossible to analyze these factors in the necessary detail, and this is where the benefit of independent boutiques becomes evident. This benefit however, is offset by the fact that they often are financially less well funded. This is not an easy call, and shows again that there generally is no free lunch.

Forgotten Elements In Risk Evaluation

5. COST RISK

The cost of asset management is very often neglected in clients' due diligence. These costs are dominated by manager fees, but even custody, fund accounting, audit fees, trading costs and market impact are costs that are often forgotten in risk evaluation.

Either due to laziness or inability to properly account for all these elements we often use the excuse of lack of transparency – and compare gross performance. I have seen this used not only across managers in the same asset class, but even across very different asset classes. This is obviously wrong and can lead to costly mistakes such as allocation to a manager with a high ability to deliver alpha at the top line, but who will hardly ever be able to generate net alpha for the investor who would have been better off with an index solution, or even another asset class that can offer a similar return profile. For example, it may be worth comparing listed small cap to private equity when all factors are considered.

Net performance also can be a risky measure in some cases. Some years ago I did a comparative analysis of hedge fund performance, which is generally published net of all fees. Very symmetric, but the problem is that when you start to calculate the required gross performance, the required gross alpha is often between 4% and 8% due to the 2%+20% fee structure. This is in fact at the core of the current deleveraging process. When funding was made a free commodity by Alan Greenspan during the bull market, hedge funds were able to leverage almost any type of alpha-generating strategy. If something looks too good to be true, it's probably not sustainable (as we now know).

6. BENCHMARK RISK

To avoid high management fees, the index and exchange-traded fund ("ETF") industry has been growing rapidly and giving investors access to most asset classes at a lower price. The risk with index funds is that an index can be suboptimal.

During the tech bubble for instance, the weight of some dubious IT companies reached insane levels. Part of the problem was exacerbated by strong asset flows into index-hugging strategies. Funds with large inflows had to buy ever-larger portions of these already overvalued companies, thereby intensifying the upward pressure.

Another problem is that indexes are rebalanced regularly to reflect changes in the market composition. In the real world, investors cannot always replicate these changes, typically for liquidity reasons. Most recently in 2008, the "yo-yo" pricing of Volkswagen has been a very good example of the risk involved in index management. When stocks move rapidly in and out of indexes it is almost impossible to get index-matching returns and generally replicating the changes results in high transaction costs.

Index risk is more manageable for large-cap broad indexes, but a problem remains with the smaller, less diversified benchmarks.

7. STYLE RISK

As an investor (and as an Advisory Board member of the Brandes Institute), I generally have great respect for value investing and a somewhat less favourable view of managers advocating glamour stocks or growth investing. But even value investing comes with risk.

Over the longer horizon this risk might be smaller and acceptable, but in the short term perceived risk can be substantial and some investors are not able to sleep if they own "cheap" companies. Such companies come with a higher risk of default, as we saw during 2008, and this is why having a well diversified portfolio has its advantages. Such diversification however is often not possible for an individual investor, which is why outsourcing still has a role to play in active asset management.

Final Remarks

Unfortunately, I have not been able to identify riskless investment strategies – and so far, even when I have been offered so-called "safe" deals, I always have later realised that the perception of low risk at the time was only because nobody could see the risk or because of "black swan" type

events. With the chance of high returns always comes the risk of large losses, and as most investors notoriously join the game too late, it is more often than not that they experience the sad side of a great investment case.

There is neither a free lunch, nor a guaranteed product. Recent events have proven that. You will not find good asset managers out there working for free. As investors we have to work hard to determine the risks we take. A deep understanding of what we invest in remains the most vital component of prudent risk management.

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