MANAGING RISK IN VOLATILE MARKETS

Avoiding exposure to riskier assets and varying the proportion of a portfolio allocated to different managers, depending on market conditions, are both being used to manage risk in the private banking arena. But understanding client psychology and recognising the shortcomings of many risk models is vital, writes Elisa Trovato

In asset management, risk is assessed mainly in terms of volatility or tracking error, by measuring how closely a portfolio follows the index that it is benchmarked to. Significant differences of fund performance from its benchmark, regardless whether this deviation is positive or negative, indicates some failure in the process of managing risk.

But the concept of risk is different in the private banking arena, says Manuela d'Onofrio, head of global investments at UniCredit Private Banking, Italy's wealth management heavyweight, currently managing €107bn in assets, of which €13bn came from the acquisition of Capitalia bank last year.

When liaising with private investors, risk is measured in an asymmetric way and the psychological component is much more important than the quantitative factor, says Ms d'Onofrio. "Private bankers need to be much more proactive. We cannot afford to be subjected to market trends. Our real benchmark is the absolute return of the risk free rate, the treasury bills, regardless of which benchmark is employed to build our portfolios; because when things don't go well, clients always compare their wealth management performance against treasury bills."

Investors' risk propensity tends to increase with positive returns, but when market trends reverse their risk tolerance goes to zero, she says. In addition, private clients' time horizons tend to be quite short, usually around 12 months, explains Ms d'Onofrio.

TIME HORIZON

"We cannot afford to have a time horizon of 3-5 years, like the asset managers," she says, making reference to the high sensitivity of her bank's private investors to market volatility.

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So what is the role of an active manager and how can he add value in managing risk?

"Once agreed with the client what is their risk budget - which is the maximum loss that they are willing to bear in a year - an active manager has the responsibility to evaluate when it's time to use it all or when it's time to change down," says Ms d'Onofrio.

The idea behind this is that you spend the risk budget when the probabilities for a certain type of investment, say equities, to deliver returns superior to those of treasury bills are expected to be higher than 50 per cent at least, otherwise you wouldn't take that bet, she says.

"In these uncertain market conditions we are not using up the whole 100 per cent of the risk that our clients give us, because we believe that risk is not duly remunerated currently. We are therefore keeping our clients' portfolios on an extremely low risk profile," says Ms d'Onofrio, adding that they have started encouraging their clients to reduce their exposure to riskier assets since last summer.

"We continue to be extremely cautious on both the equity and corporate bonds market; we believe that this crisis, which is mainly a banking system crisis, will have long resolution times."

SPECIFIC OBJECTIVES

David McFadzean, director of manager research within the international arm of RBC (Royal Bank of Canada) Wealth Management in London brings in a different perspective.

"We have not been recommending a particular reduction in allocation to equities to our high net worth investors," says McFadzean. In the base case allocation recommended by the RBC bank's investment strategy committee, equities are set at 62.5 per cent, which is at the high end of the bank's historical range, he says.

Unlike institutional investors, such as pension funds, which may want to achieve a specific annual growth per annum, private clients tend to think in a more tangible, less abstract way, says Mr McFadzean.

"For high net worth investors, who are real people, with families, dreams and aspirations, their biggest risk is not achieving the specific objectives they have set to achieve through their wealth management," he says, playing down the fact that people may want just to accumulate pure money or preserve it in their bank accounts at all times, even when they don't need it immediately.

These objectives that HNW investors have can include "being able to retire at 50 and buying a yacht to travel around the world in their retirement or it could be charity or philanthropy," or even saving enough money to pay off the mortgage, for example, he explains.

At the Canadian bank, virtually the totality of the new discretionary money coming in flows into the manager of manager programme, which includes around 15 different external providers, employed on a sub-advisory basis, as well as 6 or 7 funds, explains Mr McFadzean, who used

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to work for manager of manager firm Russell.

But manager selection itself introduces another type of risk which needs to be managed. "The most obvious risk is that you select a manager based on a particular set of circumstances, including their historical performances, the people and the products that they have; and then that changes," says Mr McFadzean.

"But we try and mitigate that risk by selecting a whole range of investment managers who are specialists in their particular area. That reduces the risk of putting all your eggs in one basket," he adds.

Changing market conditions can also prove risky but Mr McFadzean says that by picking a combination of managers "that are expected to outperform in a wide variety of market conditions," they don't have to drop and change their managers on a regular basis. "On average, we may change one or maybe two managers at any 12 month period," he says.

If the market conditions change, it is important for the manager to be able to adapt to those changes. When RBC puts together a group of managers, based on observing the risks they are taking, and that risk changes, the bank must be able to monitor what the

implications of this change is for the overall portfolio, he says.

One weapon which RBC has in its arsenal is being able to vary the proportion of a portfolio allocated to those managers, depending on market conditions. In the larger asset classes, the RBC manager of managers unit employs a core satellite approach, where anchor managers taking a lower level of risk are combined with satellite managers, who have higher return targets.

UNREALISTIC ASSUMPTIONS

According to Edhec Business School in France, in the asset management industry Value at Risk, (VaR) which measures the maximum loss that can occur with a given probability, defined as the confidence level, over a given period of time, has become as popular as portfolio volatility as a risk measure.

"In principle, volatility is a very limited risk measure. This is because it just looks at fluctuations around average return, so it gives you just an idea of normal risk in regular market conditions" says Felix Goltz, senior research engineer and co-author of Edhec's recent study on investment practices.

If the popularity of the more sophisticated VaR, by computing the risk of a loss, is encouraging at first sight, a further probe into the assumptions underneath makes these calculations neither relevant nor realistic, says Mr Goltz.

In fact, investment specialists just assume a normal distribution of returns, which does not take stock market crashes, for example, into account. "The way most people measure risk doesn't take into account these extreme events; they really look at the variation in normal times, which makes it quite pointless to compute value at risk," he says. "You might just as well stick with volatility, as normal distribution is entirely defined by the volatility and the mean return. Basically you are not adding any information whatsoever."

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Calculating value at risk in this approximate manner can do more harm than good. "My interpretation of this fact is that perhaps asset managers know that their clients are concerned with value at risk but they don't really make an effort to compute it in a sophisticated way. By doing this, they will probably underestimate the true risk for investors."

The solution would be to use techniques, such as the extreme value theory, which models explicitly extreme events, rather than ignore them.

Daniel Briggs, head of global balanced funds at Sarasin & Partners states that the statistical period on which predictions are based is extremely important. Risk models can't just look at consistently good or bad periods, as that impairs the solidity of the results.

At Sarasin, they tend to use 10 year models to compute value at risk for their target return funds. The longer time horizons will therefore take into consideration the dot com boom, the bear market equities between 2001 and 2003, the subsequent bull market and the current credit market crisis, says Mr Briggs.

NEBULOUS CONCEPT

Today, people observe that a lot of extreme events - that should not happen more often than every 100 or every 50 years - are currently happening every month or so, says Mr Briggs. "This is because the statistical models themselves are flawed, as they are not looking back over a significantly long period and therefore they are just missing these facts."

It is also possible that derivatives and more sophisticated products generate a compounding risk, which will create further distortions in the output of these old fashioned risk models.

Moreover it is not just possible to model certain things like confidence for example, he says, commenting on the recent credit crisis.

"Confidence is a nebulous concept and the problem

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with banks is that they are leveraged vehicles, they have very small amount of capital for large amount of assets and a very large amount of liabilities. It doesn't really take that much for that very small amount of equity to diminish in relation to a very small movement in the assets or liabilities," he says.

"But what financial markets hate most is uncertainty and at the moment we have maximum uncertainty."

This uncertainty or fogginess, the way Mr Briggs call it is reflected in the low volatility of his target returns funds, currently 4.5/5 per cent, placed at lower end of their spectrum, ranging from about 4 per cent to 12 per cent volatility, explains Mr Briggs.

A NEW KIND OF LIQUITITY RISK

"There have always been periods of uncertainty but what is new in this market crisis is the lack of liquidity in market segments that have never been illiquid before, such as credits or part of the money markets," says Dr. Andreas Schmidt-von Rhein, responsible for risk management and fund control for asset management at Sal. Oppenheim Group subsidiary OPAM, specialised in

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fund administration and services for the fund industry.

This shows that there is still a lot of research to do on how to measure the liquidity risk, he says.

"This is a very hot issue at the moment, because it is not easy to find a measure for liquidity," he says. The traditional measure of liquidity and illiquidity, the bid/ask spread for assets which is the difference between the price available for an immediate sale (bid) and an immediate purchase (ask) just captures part of the truth, says Mr Schmidt-von Rhein.

Small capitalisation, for example, traditionally indicates that there is some kind of illiquidity but at the moment small cap equities are probably much more liquid than asset backed securities, which have very high market capitalisation or issue volumes, he says.

COMMUNICATING WITH CLIENTS

Currently, there is a huge and increasing demand from clients for explanations of risk. One way to help them is through scenario analysis, to demonstrate the implications for their portfolios in the future. Mr Schmidt-von Rhein says many institutional risk management techniques – born from the demands of supervisory boards - are increasingly being applied to wealth management.

"We have learnt a lot about risk control and attribution in the last few years, and I think private banking can profit a lot from that."

But the fast evolution of technology does not necessarily protect clients from the fallibility of risk management techniques in private banking, where the behavioural finance component is so important, says UniCredit's Ms d'Onofrio.

"Surely, compared to the past, we have now got very sophisticated analysis systems. Some risk parameters can't be anything else than quantitative and have to be monitored over time, therefore you need very developed IT systems. But ultimately, what really counts and makes the difference is the common sense of the investment specialist who liaises with the client," she says.

In fact, most of the mistakes made in risk management derive from the inability of the private banker to understand or perhaps interpret clients' desires.

"Risk management techniques are very fallible [in private banking] and derive mainly from not understanding the client," says Ms d'Onofrio.

"When you underestimate the message that the investor gives you, often you may take the wrong decisions. It is very important in our job to really understand the client psychology," she adds.