



KEY POINTS

- Analysts and portfolio managers are evaluating whether their firms' underlying models, assumptions, and processes need to be redesigned.
- Some are implementing broad changes while others are only "tweaking."
- Risk management has become more deeply interwoven with investment firms' daily concerns and operations.
- Frequent communication among departments within firms, as well as with clients, is becoming a key change.

Rethinking Risk

Are post-Lehman efforts to revise risk management models and processes "like putting in a fire alarm after the building has already burnt down?"

BY LORI PIZZANI

The credit crisis and subsequent recession have caused some deep introspection among analysts and investment managers alike. Could better risk models have mitigated some of the performance pain that ensued? Should traditional thinking be replaced by a new conceptual paradigm that can be incorporated into the broader investment process?

"Having been through this, I think we've learned that there are significant limitations," says Joshua Kruk, CFA, head of portfolio construction and risk management at Dwight Asset Management in Burlington, Vermont. A lot of the risk management platforms being used industrywide were driven by quant models that simply failed. A metric such as value at risk (VAR), which has traditionally been used to measure balance sheet risk, depends heavily on historical correlations and valuations. Using that metric in 2006 would have underestimated the amount of true risk, but today, coming out of extreme volatility, the same VAR measurement can overstate risk and mask real opportunities. The metric also penalized any asset that exhibited volatility.

According to Kruk, the process of relying on quantitative models is being replaced in favor of a qualitative approach to risk management. And his story is part of a larger narrative involving the entire investment industry.

Restoring Communication

"Risk management has been siloed and fell victim to a degree of complacency,"

Kruk says of the investment management industry. In his view, the solution lies in developing a robust channel for communicating across an organization—from the buy side to the sell side. For example, some analysts looked at asset-backed securities or collateralized debt obligations and saw



Kruk

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too much leverage and underwriting going off a cliff. "But that analysis was never communicated to other parts of the organization; no cross-pollination took place," Kruk says.

"What you'll see is that it all gets back to communications," he adds. "There's no such thing as too much communication." His firm now holds daily formal meetings attended by department heads across the entire company. Dwight Asset Management sends its fixed-income managers to equity conferences to learn about things they might not be exposed to otherwise. The company also formed an exploratory group several months back and changed some individuals' responsibilities to align them better with risk management. As part of its internal reassessment, the firm changed the way it uses indexes as benchmarks.

Tweaking vs. Overhauling

Simple tweaking has been the favored method of adapting to the new investment environment for John Williams, CFA, principal and chief investment officer for fixed-income strategies at Barrow, Hanley, Mewhinney & Straus, a value manager in Dallas, Texas.

On the fixed-income side, the firm's process begins with its proprietary relative-return models, which are used by managers to identify bond sectors that offer opportunities. Next, qualitative analysis is applied. Small tweaks have been made to that step as well. For example, Williams runs scenario analysis to measure the risk-reward tradeoff of portfolios.



Williams

Changes have also been implemented in the way the firm measures the fundamentals of individual credits. This adjustment is especially important for analyzing companies that have historically relied on leverage.

"We think the future cost of capital will be higher, so profitability for these companies will be lower," he adds. "We always have cyclical credits, but this time around, we're seeing businesses that can live with less leverage. That's quite different from what we've seen over the last decade."

After the Fire

Of course, not all investment professionals are making significant changes to their underlying assumptions or investment processes.

One manager who hasn't revised his risk management process as a result of the financial crisis is Benjamin Nahum, managing director and portfolio manager of the Greene Group, a value portfolio management team with Neuberger Berman in New York City. "I was reluctant to put in risk controls after a down year," he says. "That's like putting in a fire alarm after the building has already burnt down."



Nahum

Nahum's firm did most of its retooling in 2001 and 2002. "At that time, we reengineered," he says. "We looked at what went wrong, what had been the weak links in our process. We asked, 'How do we change our process?'" Nahum and his head of small-cap screening undertook a thorough review and identified some of the factors that had produced problems for the value stocks, including small-cap stocks, in which his team invested.

The analysis found that the greatest pain was felt when these corporations' balance sheets reached certain levels of stress in combination with a shutdown in capital markets. So, a new screen was devised to give each of these companies a quality score based on a combination of factors, including the amount of leverage each portfolio company employed and each company's cyclical returns.

That new metric helped the Greene Group navigate the markets pretty well. "Into mid-September, I think we had an accurate handle on our risks," says Nahum. "We knew who the problem children were." Then came Lehman.

No one anticipated that when Lehman failed the capital markets would have so quickly and violently shut down to everyone and everything. The market freeze showed Nahum's

team another layer to pay attention to—that the violation (or even the perceived threat of a violation) of a company's loan covenant would send the company's stock price tumbling. Nahum's team then had to determine how much of the price decline was attributed to earnings erosion versus credit risk. Although no underlying processes were changed, Nahum says he redeployed assets from his low-conviction companies to those about which he had a high degree of conviction.

"We're in for a Long Ride"

Not much changed within the usual process of analysis that Craig Elder handles. As fixed-income senior analyst for Robert W. Baird & Co. in Milwaukee, Wisconsin, he manages a department that works with Baird's 600 financial advisers who serve retail customers in building portfolios.

"We missed Lehman," Elder admits, although he knows he's in good company. "As far as investment management, I don't think the output we do has changed."

"We spent long hours in the office hand-holding, but it's abated now," he says. Elder's area at Baird is back to issuing its one-page reports on companies, mostly financial services companies.

"Individuals who buy bonds are looking for income," he says. "We're happy as long as there are no defaults which kill the income stream." The industry, however, may be in for additional bond defaults. Noting that Moody's has predicted that defaults may go as high as 12 percent of all issues by the end of 2010, Elder adds, "We're in for a long ride."

Execution Evolution

A combination of luck and skill allowed Sectoral Asset Management of Montreal, Canada, to sidestep the Lehman debacle altogether. A niche firm that invests exclusively in health care, biotech, and genetics companies (predominantly as a subadviser to other companies' funds), Sectoral ceased executing portfolio trades with

Lehman 10 days before the firm blew up. Sectoral's personnel had been closely watching Lehman's deteriorating financial condition and decided to pull the plug. "Our concern was, 'Who takes the hit if we have outstanding trades with them that haven't cleared?'" says Michael Sjostrom, CFA, chief investment officer at Sectoral. "Either way, this was not acceptable. It was not a risk we wanted to take."

Since that artful dodge, the firm has enhanced its usual quarterly execution services review and now keeps a closer credit watch for the execution trading partners (nearly a dozen) through whom it clears trades. "We put the whole credit watch concept back on the workbench and asked, 'How can we monitor our trading partners?'" says Sjostrom.



Sjostrom

Sectoral decided that independent credit ratings from rating agencies were simply not reliable. "The problem with credit-rating agencies is that all they do is run after the ball," he says. "They never get ahead of it." So, the firm reached out to communicate directly with each trading partner and made them aware of its concerns. It also ceased trading with one company the firm had reservations about after scrutinizing its balance sheet and chose not to begin execution services relationships with others. ▀

Lori Pizzani is an independent journalist based in Brewster, New York.

RECOMMENDED RESOURCES

"What Volatility Tells Us about Diversification and Risk Management"
Conference Proceedings Quarterly
(September 2009)
(www.cfapubs.org)

"Nickels in Front of the Steamroller: The Return of Qualitative Risk Management"
CFA Institute Webcast
(www.cfawebcast.org)