Why does Risk Matter?

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The noted investor Benjamin Graham was quoted as saying, "The essence of investment management is the management of RISKS, not the management of return." (It is important to note that he said that nearly 100 years ago.)

When you consider the various topics that most pension boards discuss during the investment portion of their meetings, the topic of risk and/or volatility is rarely mentioned. We can all agree that most investors prefer higher returns with lower risk. Discussion surrounding investment returns dominate the investment review; however, risk is rarely discussed despite the efforts of investment consultants and managers who often provide risk measures within their reports.

Why does risk matter and why should it garner more attention? Pension funds have a long-term investment objective; however, the annual contribution amounts and benefit negotiations fluctuate over much shorter timeframes, sometimes year-to-year. These variations make it extremely important for a pension fund to measure and understand the need for less volatility and risk. A fund with higher volatility is exposed to large fluctuations in expected returns and pressure to maintain consistent benefit payments, funding requirements and ratios. This volatility has secondary effects that may cause pension boards to change their investment allocations within short timeframes. Increased volatility may also lead to the well-known mistake of "hiring high and firing low." This is not the way to properly manage a pension fund with long-term investment objectives. In the end, pension board members need to understand the volatility and risk of each of their investment managers in order to identify if those measures fit within the long-term investment objectives of the fund.

How do we best measure risk and volatility? The two measures that are utilized across the investment industry are Standard Deviation and Sharpe Ratio, measured over three or five year timeframes. Standard Deviation measures the variability of returns around the mean (average) return, and it illustrates how broadly past performance has been distributed by a fund manager. The Sharpe Ratio was developed by Nobel Prize winning economist William Sharpe, and it is considered one of the main "quality control" checks that investors need to make on their investments. The Sharpe Ratio is a reward-to-risk ratio, and it works in conjunction with the investment goal of high return per unit of risk. When evaluating these measures most investors seek portfolios with low Standard Deviation and high Sharpe Ratios. The application of these risk measures should start at the manager level, and then these measures can also be applied to the total fund and its comparative index.

Warren Buffet, an investment disciple of Benjamin Graham, was quoted as saying, "The rear view mirror is always clearer than the windshield" along with a slightly funnier quote "only when the tide goes out do you discover who's been swimming naked." The historical measures of Standard Deviation and Sharpe Ratio provide a very clear picture of the relative volatility that a manager or fund could produce in the future as well. When an investment manager with higher measures of risk is added to a fund, the overall pension fund risk is also increased and the predictability of forecasted returns and associated asset allocation studies is hampered due to the manager's increased return volatility.

As stated earlier, investing IS risk management and, as a pension board gains a greater understanding of its overall risk and ways to reduce it, different asset allocations can be applied. A diversified fund that contains lower risk managers can actually increase their equity allocation without increasing their overall risk profile. Many pension funds have been changing their asset allocation recently and have decided to increase the exposure to Equities in light of the expected returns for Fixed Income.

Now more than ever, trustees need to fully understand the risk profile of their investment managers and their overall pension fund. Examining Standard Deviation and Sharpe Ratios will provide fund fiduciaries with the knowledge they need to make the proper asset allocation decisions. Risk does matter because making an allocation to lower volatility equities will help with achieving a pension funds objective of higher returns with lower risk.