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Rethinking Global Risk Management

Looking beyond historical data raises the status of security selection

Portfolio risk management has traditionally

involved setting limits for overweighting or underweighting asset classes, sectors and individual securities. Today, however, new techniques can be used to measure and understand the risk of a multi-asset class portfolio, resulting in a truly global approach to portfolio management.

Risk management begins with the information ratio which links a manager's value added with its active risk. It is defined as value added divided by active risk and it tells us about the quality of the information from which portfolio management decisions were taken. For traditional asset classes, an information ratio of 0.5 is excellent.

A manager's risk limit can be set as a function of its value-added objective. For example, assume that a reasonable value-added objective for a Canadian equity portfolio manager is 100 basis points. Once an objective is determined, a risk limit can be established using a target information ratio. Given that an information ratio of 0.5 is typically first quartile (zero is median), a ratio of 0.25 is appropriate for risk-budgeting purposes.

Active risk budgeting is all-encompassing. It gives a portfolio manager more flexibility as only one constraint—active risk—has to be monitored, as opposed to a set of sectorial and individual securities limits.

GLOBAL MANAGEMENT

The importance of the new risk management approach is most evident when it is applied to a plan-wide portfolio. Thanks to recent technological developments, the active risk of a multi-asset class portfolio can now be aggregated and, as a result, managed. This evaluation must take into account the diversification resulting from the strategy used in each asset class. A simple weighted average of the

risk for each class is not sufficient for an adequate evaluation of the global risk. New techniques are now available for this important evaluation.

This aggregation can be used in several portfolio management applications. For instance, it is possible to detect a situation where all portfolio managers have adopted a strategy tainted by the same macro-economic outlook, amounting to excessive global portfolio risk. If all managers of a multi-asset class portfolio are influenced by the same interest-rate forecast, for example, and adopt strategies in accordance with it, then the global portfolio might carry an unacceptable risk level owing to the lack of strategy diversification.

Chief investment officers would be interested in monitoring global risk, diversification, and, if necessary, making adjustments to strategies. With the help of this new metric, risk management has evolved from a risk-limiting or defensive role to a risk-optimizing and offensive role. In fact, portfolio risk can be adjusted to improve the chances of meeting a set of objectives, globally and for each asset class.

The above approach can also be used to manage a multi-manager program within an asset class. In this case, asset classes become manager mandates and asset mix risk become mandate mix risk. Sources of risk can be identified between managers, and more importantly, between sector and stock selection across the entire asset class. With the help of this analysis, important adjustments can be made to the portfolio to decrease or increase sector risk that otherwise would not be apparent to individual managers.

Recent advances in portfolio risk evaluation are resulting in a new approach to risk management that allows pension fund administrators to monitor and evaluate their managers more effectively. At the same time, investment management firms and chief investment officers can improve the construction of their portfolios on a global basis by taking into account the risk concentrations that arise from asset class strategies. ■