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Belvest 研富

Risky business

by Stephen Nguyen

Everyday decisions involve making balanced judgements between risks and rewards and we are essentially hardwired as humans to be natural risk management machines. Whether we realise it or not, we are constantly evaluating risks in every aspect of life, including social and professional settings, yet surprisingly and in spite of its crucial role, risk management is often seen as 'boring' and therefore tends to be overlooked. Whether we're making personal or investment choices, these always come with an element of risk. Therefore, it pays to thoroughly understand the risks involved in any venture, so that they can be managed and minimised.

Risk models are a useful place to start as they provide high-level insights. However, they shouldn't be relied upon in isolation. These models tend to be backward-looking and fail to incorporate future regime changes. It is crucial to assess risk from multiple perspectives; this includes forward-looking assessments, stress testing (what happens if past crises reoccur?) and scenario analysis (how would the portfolio behave under certain pre-determined conditions?). While models and quantitative tools are useful, they do have limitations. It is important to challenge assumptions; for example, how might a portfolio react if correlations were to deviate from historical norms, as was the case in 2022 when long-term correlations between bonds and equites broke down.

Sound risk management goes beyond standard quantitative measures like volatility and diversification ratio. Diversification should also be evaluated qualitatively, to ensure portfolio exposures don't all add up to the same kind of risk - for example, overweighting value stocks while simultaneously underweighting duration within a multi-asset portfolio.

At Momentum, we believe in blending equity style factors to deliver more efficient returns. This process involves more than just investing X% in value, Y% in quality, and Z% in momentum stocks. To achieve a balance between risk and returns, our research team look at minimising unintended factor exposures; for example, the negative value exposure that typically comes with buying high momentum stocks.

We construct portfolios by finding the right balance based on various risk and return factors, whether that's reducing tracking error, maximising information ratio, minimising expected shortfall or maximising decorrelation to fully cover all bases.

The risk of overpaying for an investment is clearly important. The best way to mitigate this is to use a robust valuation framework embedded within the investment process. At MGIM we are risk champions, and the entire team constantly assesses a spectrum of risks that could potentially derail good outcomes for our clients.

What sets a great investment manager apart from a good one is the ability to balance expected risk and return effectively to achieve desired outcomes. Investment managers face a multitude of risks, but the ultimate risk is the permanent loss of capital, something quantitative models in isolation will fail to detect.

From a process perspective, it is much better to embrace risk culturally rather than isolate it within a specific team. The risk function should not solely be focused on risk avoidance since taking risks is essential to generating returns. Collaboration between portfolio managers and risk experts is key to understanding compensated and uncompensated risks. Risk management is most effective when it is incorporated into the investment process, with risk experts actively involved in the investment decisions, working closely alongside portfolio managers. Whether we like it or not, risk is part of investing, so let's not make it a taboo subject...

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