

RISK MANAGEMENT: A TACTICAL MULTI-MANAGER APPROACH

OPENING

It has long been respected that the goal of portfolio management is to maximize returns in consideration of the risk taken. While this goal is rarely questioned, it has also been said that you can't "eat" risk-adjusted returns. Reflecting on this aptly put challenge, why is it then that we concern ourselves with risk? Consider the following perspective:

"In the short run, the stock market is like a voting machine, but in the long run it is a weighing machine"
Benjamin Graham

Graham, a prolific economist who is widely considered to be the first proponent of value investing, created a fictional investor, Mr. Market, in an effort to personify the potential effects of shifts in investor sentiment over time. Graham posited that Mr. Market's prices in the short run may not reflect fair value since they are partly the product of emotion and not solely of reasonⁱⁱ.

Then these times are upon us, investors may not only experience losses to their wealth, but also an inhibition in their wealth's future growth. Losses need to be regained by investors before growth can once again ensue. This means losses also have another cost, time. Since time is the enabler of compound interest – what Albert Einstein called the ninth wonder of the world – less time results in less growth. Consequently, avoidance of losses in the short run can be very accretive in the long run since "... the

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This is why we need to concern ourselves with risk, and consider more than just potential returns. The purpose of this paper is to evaluate various approaches to mitigating risk. Those approaches will be examined within the context of portfolio management, the markets today, and implementation challenges.

PORTFOLIO MANAGEMENT

Mitigating risk can positively impact investor behavior. When investors think of risk, they are most often focused on downside risk or losses in lieu of total volatility. This is a result of our loss aversion^{iv}. Put simply, investors strongly prefer avoiding losses to acquiring gains. Perhaps investors have an innate desire to mitigate risks?

Portfolio managers, like investors, can also benefit from less downside risk. Less risk can produce two positive outcomes: their investors will make more money and their assets under management will remain more stable. First, statistics indicate that investor returns over time capture more of a mutual fund's total returns when funds are less volatile^v. This is the result of investors who buy and hold in lieu of chasing returns. Second, the same statistics^{vi} illustrate that investors in volatile funds have greater

tendencies to chase returns and capture less (sometimes much

less) of the fund's returns over time. This chasing behavior results in poorly-timed cash flows for portfolio managers making their job more difficult. From this perspective, it seems that both investors and managers alike can benefit from, and should be interested in risk mitigation.



Portfolio managers have different approaches in which they can attempt to mitigate downside risk. Of course, these methods themselves have their own advantages and disadvantages. The following is a basic review of the four approaches:

Hold More Cash

Cash is very beneficial in a down market. It not only holds its value, but it also provides the “dry powder” to buy securities that Mr. Market has mispriced. However, since the market tends to increase over time, cash balances become a drag on performance. Of course, if one has the ability to time the market - be in cash when the market is dropping and fully-invested when it is going up - then no other approach is necessary. One needs only consider that other approaches exist because successful timing has proven to be very difficult, if at all possible. There are two more disadvantages to holding cash in a portfolio: investors do not like paying management fees on cash, and cash allocations are generally factored into other parts of investor asset allocations.

Hold Less Volatile Securities

This seems more straightforward than it is. Sectors and securities come in and out of favor during market cycles and their own security-specific (idiosyncratic) life cycles. None are immune from volatility. Dividend paying stocks, for example, have long been considered among the safest of all equity securities. However, if a dividend-paying company cuts its dividend, its volatility jumps. Of course, it's not only the volatility of an individual security that matters, but also how it correlates with other securities in the portfolio. It's not about the volatility of any individual security, but rather the volatility of the entire portfolio.

Hold More Securities

Research^{vii} has shown that during periods of high market volatility and cross-sectional dispersion (disparity in style performances), expanding the portfolio to be more market-like avoids the increased idiosyncratic risks found in concentrated portfolios. While this works, owning more securities cannot help during systemic shocks (i.e., 2008).

Furthermore, periods of high market volatility and cross-sectional dispersion make profit opportunities available to those who, according to Warren Buffet, are greedy when others are fearful. Concentrated portfolios or simply portfolios that differ significantly from their benchmarks offer potential for increased return -

Recent research^{viii} has found that the decision to retain active management should consider that management's willingness and ability to take positions that are different from its benchmark – its “Active Share.” The study demonstrated that the greater a portfolio deviates from its benchmark, the greater potential for alpha from active management. It is important to note that the portfolio deviations in the study were only under/over weights of the benchmark's holdings.

Nevertheless, challenges arise when specific styles of management become out-of-favor. In order to remain successful and fully-invested, management would need to take positions that are outside of their benchmark's holdings. This is referred to as style “drift”. Consider an equity portfolio assembled out of multiple managers in which each manager was hired based on their demonstrated competencies in specific styles of management. If one of those managers begins to own securities outside of their style, then that drift would simultaneously leave a gap in the portfolio's diversification and become over-dependent in another style.



Less diversification by definition increases the portfolio's risk.

Add Portfolio Hedging

Hedging done successfully via the use of futures, options, or shorting selected securities can mitigate losses. These tools and techniques can derive profits from markets, styles, sectors or securities that decrease in value. Hedging with tools such as futures and options includes leverage, increasing sensitivity to market gyrations. This can be a double-edged sword. A small hedge may protect a large proportion of a portfolio, but it also means that mistakes can be very costly. At a minimum, there are costs to hedging. Portfolios should not always contain hedges. As a result, hedging of a portfolio's risks (i.e., an overlay strategy) or risks in the marketplace (i.e., a macro strategy) is best accomplished by active management. The valuation or price of a hedge is critical just as a value investor's entry point. Interestingly, when there's little concern or perception of risk, hedges are relatively inexpensive. Conversely, when markets are scared or worried, hedges can be too expensive.

Referring back to the Active Share concept, what if in lieu of drifting, management chooses to actively under weight benchmark positions via short or hedged benchmark holdings? This could maintain the integrity of the diversification strategy given the style's near-term potential. While the study on Active Share does not cover shorting/hedging specifically, it found that "...funds are most active when their benchmark index has gone down in the past few years relative to the other indexes." Furthermore, "...on average, more style-consistent funds outperform less style-consistent funds. This finding appears to be driven by the strong performance of

style-consistent funds in rising markets; in down markets, less style-consistent funds exhibit relative outperformance."^x The literature seems to support the benefit of taking more active risk even including style drift when the markets are experiencing reversals (losses.) In fact, "the ability to short a modest amount allows a skilled manager to increase the expected active return with no commensurate increase in active risk..."^x Shorting/hedging in lieu of drifting seems to offer the best potential cost/benefit

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proposition, and specifically so within the context of a portfolio.

The four reviews of the basic approaches, if nothing else, illuminate challenges to risk mitigation. It comes down to a cost/benefit analysis as to which approach (or combination thereof) can maximize returns in consideration of the risk taken. In the portfolio context, it seems that a style-consistent, high active share portfolio that opportunistically hedges risk might offer the optimal combination of techniques. However, a question remains as to the applicability of such a strategy within the context of today's marketplace.

MARKETS TODAY

Regardless of how one feels about market efficiency, markets do seem to be getting more efficient if only by definition: there are more competitors, the competitors are more educated, and more information is flowing and faster too than in the past. The implications of this may be lower returns and higher volatility in markets going forward. In fact, market cycles, themselves, today do seem faster^{xi} than in the past. This is the result, in part, of the increased globalization and securitization of our markets. At any rate, 2008 taught us that systemic risks are higher



than in the past. Overall, it seems to imply that long-only management may be getting riskier.

The result seems to have been increased interest in active management with a focus on risk management similar to the original premise of a “hedged” fund^{xiii}. This is illustrated by headlines such as “Long/short cutting into long-only action.”^{xiii}

One style of long-only management that had survived volatile times well in the past was fundamental value. This style of management only bought securities that offered a “margin of safety”^{xiv}, or essentially good businesses for very good prices. Unfortunately, 2008 proved that there are markets in which even margins of safety cannot prevent significant losses. When asked what they would do differently going forward, some of these managers responded that they were no longer going to ignore the macroeconomic environment. Ironically, this answer was essentially going backward since “Graham and Dodd view macro factors... as crucial to the analysis of a corporate security.”^{xv} Simply considering a macro factor alone doesn’t mitigate risk, what matters is how the new information is acted upon. For example, if hedging techniques are not part of the long-only, fundamental value manager’s skill set, and these are separate skills, the challenge is tougher. Value managers are not likely to become more index-like or market timers.

The systemic shock of 2008 was a key driver behind the growing interest in hedge-styled management, and the interest seems to continue to be growing. However, 2008 also illuminated risks that can be inherent in hedge funds: excessive leverage, a lack of transparency, a lack of liquidity, and high

expenses. Of course, investment schemes that weren’t about investments at all, frauds, also came to light. As Warren Buffet said “its only when the tide goes out that you learn who’s been swimming naked.” For all of the unflattering press mutual funds received in recent years, the registration tenets of the Investment Company Act of 1940 negate the risks that can be inherent in hedge funds.

It seems the markets of today could benefit from a combination of the active management techniques inherent in hedge funds, and the structural benefits of registered mutual funds.

THE IMPLEMENTATION CHALLENGE

The concept of a style-consistent, high active share mutual fund portfolio that opportunistically hedges seems fairly straightforward. However, the successful implementation of this type of strategy is quite difficult. It compounds the challenge of finding a skilled long-only manager with one who has also demonstrated hedging skills. Consider one component of opportunistically hedging, shorting weak and overpriced stocks:

- “It should not be assumed that a process that is successful on the long side will be similarly successful on the short side.”^{xvi}
- “Shorting stocks is not a natural extension of fundamental stock analysis... Long-only analysts and fund managers usually focus their efforts on those stocks likely to be the best outperformers, rather than diverting resources to identifying those likely to be the worst underperformers.”^{xvii}

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It is not that a single manager cannot manage both long and short well, but rather that these

two mind sets are very different.



The successful management of shorts is significantly more difficult than long-only management due to: high costs, liquidity challenges, the theoretically unlimited loss potential, and the pervasive challenge of mistakes becoming larger proportions of your portfolio. These difficulties are in part why there are so few dedicated short as compared to long-only managers. In comparison, hedging via the use of futures and options contracts: lowers the cost burden, poses few liquidity issues, losses can be limited to the contract's cost (options only), mistakes become smaller portfolio allocations (options only), and the contracts have tax benefits^{xviii}. This is why these tools are used by managers who opportunistically hedge. Then again, logic extends a similar disconnect between the skill sets of hedgers who use options/futures and long-only fundamental managers.

It seems the long and hedged aspects of this portfolio concept are somewhat mutually exclusive. As a result, the implementation challenge shifts from finding one manager to possibly pairing two managers in one portfolio: a long-only, high active share manager with an opportunistic hedge manager. While pairing two managers would seem to be far easier than finding one to satisfy the dual mandate, the two would need to interact with

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an uncommon level of cooperation. Specifically, the opportunistic hedge manager would need real-time access to the long-only portfolio manager's positions, and mitigate risk in a manner that is not deleterious to the manager's assets under management. If successful, the hedge manager's role would not only mitigate downside risks, but also generate upside returns.

CLOSING

At the opening of this paper, the question of why we concern ourselves with risk was asked. We concern ourselves with risk because most of us save and invest to meet our goals (future liabilities) and there can be very real costs to falling short. Most of us do not invest for the sole purpose of building wealth. Furthermore, too often our time and savings are in very short supply. Investment losses are too expensive. In addition, we don't need anymore obstacles to reaching our goals (meeting our liabilities.)

While not a per se implementation challenge, there are hurdles for the money management industry. Are firms willing to offer a fund to investors that deliver...

1. Hedge-styled management at mutual fund pricing
2. The daily liquidity of a mutual fund
3. The transparency of a mutual fund
4. The structural safeguards of a mutual fund
5. Broad availability to non-accredited investors

Finally, with the uncommon level of cooperation necessary between the two distinct managers, the ability to have demonstrated success across different market cycles would be essential. The goal would be to maintain the long-term growth opportunities of being a long-only equity investor with significantly less volatility in the short run.

We can and should endeavor to hope for funds that meet the challenges of today's markets.



i Graham, Benjamin (2003). *The Intelligent Investor A Book of Practical Counsel*, rev. ed. New York: Harper Collins Publishers, p. 477.

ii Graham, Benjamin, Dodd, David (1934). *Security Analysis*, New York: McGraw-Hill Companies, Inc. p. 28.

iii Bernstein, Peter L., *When the Long View Isn't So Scenic*, New York Times Business Section, March 30, 2008. p. 5.

iv 2002 Nobel Laureate in economics, Daniel Kahneman, *Prospect Theory*

v Morningstar asset-weighted averages, 10-years ending 12/31/2009

vi Ibid

vii Repetto, Eduardo A. and Rodríguez Jacobo L., *Market Anxiety*, Dimensional Fund Advisors Quarterly Institutional Review, Third quarter 2008.

viii Cremers, Martijn and Petajisto, Antti, 2007 "How Active is Your Fund Manager? A New Measure That Predicts Performance" October.

ix Brown, Keith C. and Harlow, W. Van, 2005 "Staying the Course: The Impact of Investment Style Consistency on Mutual Fund Performance" November.

x Clarke, Roger G., de Silva, Harinda and Sapra, Steve, 2004. *Toward More Information-Efficient Portfolios Relaxing the Long-Only Constraint*. The Journal of Portfolio Management. Fall: 54-63.

xi Rahl, Leslie "once-in-a-lifetime events seem to occur every few years" Fortune, March 2008.

xii Jones, Alfred Winslow, 1949

xiii Pensions & Investments 2/22/2010

xiv Graham, Benjamin (2003). *The Intelligent Investor A Book of Practical Counsel*, rev. ed. New York: Harper Collins Publishers, p. 301.

xv Whitman, Martin (1999), *Value Investing: A Balanced Approach*.

xvi Philips, Christopher B., Kinniry Jr Francis M., *Removing the Long-Only Constraint: The Appeal and Challenges of Implementing 130/30 and Other Long-Short Strategies*, Vanguard Investment Counseling & Research (2007), page 16

xvii *A Triumph of Marketing Over Performance?*, IPE.com, 11/13/2008

xviii Gains from these contracts are taxed as if 60% were long-term holdings regardless of the holding period. Gains from short sales have no such benefits

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