One day at a time

Nadine Wojakovski examines the day-to-day investment risks that trustees need to monitor

Summary
• Day-to-day management of a scheme's investment flows from the strategic level, eg what increase in the deficit the scheme is willing to tolerate.
• Some areas of risk can be managed through quantitative measures, but monitoring political risk requires good governance to be in place.
• Managing liquidity risk requires a pragmatic understanding of liquidity in stressed terms.
• Trustees should be careful not to overreact to every day-to-day market issue. Instead trustees should have a realistic understanding of the risks and the possible losses that it may generate.

Managing pensions is a long-term, strategic business that is frequently in the spotlight. But beyond the quarterly strategic meetings there are many day-to-day investment issues that need to be monitored to ensure the effective running of the scheme. The all-important question is how robust are the investments to what might happen in between the quarterly meetings?

"When we talk to pension funds they predominantly have a good idea about their risk control of a specific investment. However there is less risk control on the overall portfolio, where there are lots of investments doing different things," notes investment consultancy bfinance director and head of risk management Dr Toby Goodworth. This makes it harder to predict day-to-day situations. Consequently he helps clients 'get a handle' on their overall portfolio as he believes that day-to-day management of a pension fund portfolio is as much about risk control as it is about strategic asset allocation and manager selection. "It is about understanding what could happen around the corner, which leads to less knee-jerk reactions," he explains.

Most pension experts are united in agreement that the day-to-day management of a scheme's investments flows from the strategic level. It is a case of, for example, how much exposure the scheme wants to take and what increase in the deficit is it willing to tolerate, in a prudent worse-case scenario," observes Redington's investment consulting team senior vice president Sebastian Schulze.

"For example, take currency risk," says Schulze. "You need to ask, what do I want as an overall risk budget, and how much of that total risk do I want to allocate to currency risk?"

That then defines how much currency risk the scheme needs to hedge as part of the day-to-day operations.

Liquidity risk

With regards to liquidity risk, Schulze says the scheme needs to assess the split of its portfolio between illiquid assets – such as private equity, and very liquid ones – such as equity, and then those in between. The questions then must be:

"What risk does this choice of assets imply? Will I be able to re-position my portfolio quickly and cheaply enough if I need to raise cash or react to market movements?"

Again, he says, a framework that defines what exposure the scheme feels comfortable with is important, in order to manage it on a day-to-day basis.

In general the more complex the strategy the more room for illiquidity to creep in, opines Goodworth. "You need to have a pragmatic understanding of liquidity in stressed times – such as acknowledging that potentially not just you, but all other investors want to get out of that investment at the same time." Indeed, he notes that risk management is about managing something you might want to 'change', but if you are unable to get out of a position, then you cannot actually change the risk. So it comes back to ensuring that there is a robust diversified portfolio in the first place.

"In general the more complex the strategy the more room for illiquidity to creep in"

Liquidity risk is one of the day-to-day risks that can create some "nasty surprises," says consulting firm Cardano UK CEO Kerrin Rosenberg. This is the inability to sell your investments at a 'reasonable price' quickly when you want to. "Note the important phrase 'at a reasonable price,'" says Rosenberg, "as you can normally sell illiquid assets at ridiculous discounts if you really need to exit."

Volatility

Melissa Brown is the senior director of applied research at risk anaylsis and portfolio management firm Axioma. She works with clients who are doing day-to-day portfolio risk management, with a focus on how they manage the risk return trade-off.

As an example of the acute need for day-to-day risk management, Brown points to the recent period between September and December 2014. During that time oil prices were plummeting, the market values were plummeting but at same time the volatility of the energy stocks was rapidly increasing. So for those investors with a view on energy stocks, suddenly any

bet for or against energy became much riskier, likely making the overall risk of the portfolio higher as well.

This situation demonstrated that while, over the long run, energy stocks are not more volatile than others, at a point in time, they may be. And when that happens investors may need to rebalance their portfolios to reflect the new risk regime. But the degree of rebalancing depends upon the investors' risk appetite.

Brown says: "Many of our clients use 'optimisation' so they create a portfolio with a particular level of active risk or tracking error. They may have noticed at some point they met their tracking error targets, but suddenly risk moved above those risk targets. So then they would rebalance portfolio to bring the risks back in line."

Alternatively, other clients who may not be so quantitatively driven, would probably more likely prefer - rather than a mechanical rebalancing - to dig deeper in their expectations of what is going to happen to energy and make sure the benefit (expected return) outweighs the cost (risk). In this scenario, she says, they use judgment rather than optimisation to rebalance the portfolio.

"It is good for trustees to understand what is driving the volatility of their portfolio," says Brown. "Most managers produce risk reports. Having a good understanding of what each manager is doing and how it fits in the plan is critically important."

Balance

But, she warns that trustees should be careful to not overreact to every day-to-day market issue – and must also acknowledge that with the markets the way they are, those day-to-day fluctuations may help one day but hurt another. "It comes down to education. If you understand what's happening in the whole plan and how things sit together, and where risks are likely to come from, it helps you avoid getting spooked or overreacting."

Goodworth says the issue is not to get lulled into a false sense of security but, rather, to get a realistic understanding of where that risk is and where possible losses could potentially come from. If, for example, equities fall, credit markets blow out and fixed income falls – in most cases most pension schemes would not be able to respond fast enough to this. Accordingly, the best line of defence is to be appropriately diversified in the first place, through a holistic risk framework. Goodworth adds: "We believe in closing the stable door before the horse has bolted rather after."

"Trustees should be careful to not overreact to every day-to-day market issue – and must also acknowledge that with the markets the way they are, those day-to-day fluctuations may help one day but hurt another"

Turning to corporate related events, such as transactions and restructuring – these can have a material impact on the ability of the company to underwrite the downside investment risk in its pension scheme.

For example, a profit distribution to shareholders could materially reduce the cash resources in the business, or an acquisition could result in significant integration costs or increased levels of debt to fund the acquisition. Either of these examples, observes Lincoln Pensions managing director Matthew Harrison, are likely to reduce the financial flexibility of the employer and the funds available to make pension contributions - at least in the short term.

"These are often one-off things, but trustees should ensure that they have appropriate protocols in place for information to be shared by the sponsor, allowing them to identify major business events at the earliest opportunity and to assess the impact of such events on the ability of the employer to underwrite the scheme's investment risk," he adds.

While some areas of risk can be managed through quantitative measures, when it comes to political risk you cannot, arguably, run a risk model and accordingly cannot really plan ahead. Instead, it is necessary to have good governance in place. Schulze says: "It is important to lay out an emergency plan detailing who makes which decisions in such a scenario. If something does go wrong you need to know who to call, be it trustee board, CIO or other."

Whatever the issue at stake, laying the foundations early on, where possible, is critically important.

Where risk can be measured, it can be tied back to a strategic plan and you can put limits in place to inform your day-to-day management of that exposure. Conversely, with risk that is difficult to capture, such as political risk, the best mitigation is to have an effective governance structure in place so you can react quickly to any new dangers.

Written by Nadine Wojakovski, a freelance journalist