March 04, 2011

Five Commandments Of Risk Management

Advisors must adapt to the post-financial-crisis environment by rethinking their approaches for managing portfolios.

By Mitchell Eichen and Mark Pearlman

Now that the trauma of the 2008 financial crisis is fading behind us, advisors can't afford to fall back on old modes of thinking. Individual investors have been deeply scarred and fundamental factors presage a bumpy road ahead--in this new environment the same-old approaches just won't do. We need a systematic framework to help advisors progress in a way that is not purely reactionary, but also practical and productive. We call this new framework Risk 3.0.

Risk 3.0 organizes the past evolution of the financial industry both by risk conditions and the strategies the industry has developed to address these conditions. In this way we can begin to better define our current, unprecedented risk environment and better evolve in response.

The starting point for this organization of investment risk management is Harry Markowitz's theory of optimal asset allocation and the development of Modern Portfolio Theory in the 1950s and '60s. These basic methods of diversification, which are still core to investing today, gave investors the tools to quantify and mitigate market risk. This we like to call Risk 1.0.

While Risk 1.0 improved the risk profile of an entire portfolio, it did not manage the risk of any particular asset. The creation of the Black-Scholes model in 1973 to price and sell financial derivatives--whether options, futures or swaps--opened the door to new tools for maximizing asset certainty. Aided by advances in computing, the quantification and securitization of options and hedging strategies lead to their widespread application in the rapidly expanding hedge fund and alternative investment universe. The evolution of this trend, when combined with Risk 1.0, was the use of hedged and other alternative investments as core portfolio holdings in new risk management approaches such as the Endowment Model. This we call Risk 2.0.

For the past 30 years, Risk 1.0 and Risk 2.0 approaches were the standard tools of portfolio management. Yet the financial crisis of 2008-2009 dramatically revealed the limitations of these methods in the face of extreme market volatility and fragile financial institutions. Now we face a new market reality defined by the combined headwinds of reregulation, rock-bottom interest rates, continued deleveraging, high unemployment and slow economic growth. Add to that an increasingly interdependent and globalized economy--in which even remote shocks can have far-reaching consequences--and the most likely market outlook is a grim blend of persistent volatility and periodic crisis. To address such a challenging environment, a new risk-centric paradigm is needed: One where return follows risk, not vice versa, and risk management methods are designed for a wide range of market conditions. This is the era of Risk 3.0.

In this respect, Risk 3.0 is both a framework for understanding the current challenges confronting the financial industry and also for evaluating new risk management methods in the context of what has come before. Risk 3.0's ultimate goal is to guide investors and professionals to pragmatic investment solutions that combine the best of previous approaches while also being optimized for current risk realities. For example, building a Risk 3.0-optimized portfolio will require more attention to the true liquidity of its assets, the credit risk of seemingly stable counterparties and the reality that correlations go to 100% when investors panic. This requires a shift in thinking from a "performance-centric" to a "risk-centric" approach in portfolio construction.

We can codify this risk-centric philosophy using five Risk 3.0 Commandments. They are:

1. Risk is central: Do not think you can know the unknowable or predict the unpredictable.

2. Risk is not uniform: Market conditions continually vary and risk takes many forms--be prepared.

3. Risk has no blanket cure: Techniques need to be optimized for different market scenarios and types of risk.

4. Risk-adjusted returns matter: You should not take uncompensated risk, but must be appropriately rewarded for the level of risk taken.

5. Risk is not static: Constant monitoring and reevaluation are required.

This is our call to action. As advisors continue to adapt to the post-crisis environment, we believe Risk 3.0 offers a framework for organizing and shaping the conversation we are already having. Change is here whether we think about it in context or not. Welcome to the age of Risk 3.0.

Mitchell Eichen is founder and CEO and Mark Pearlman is executive vice president, business strategy, of The MDE Group, a leading wealth and asset management firm with offices in Morristown, N.J., and New York City. The MDE Group has been among the top 25 of Barron's "Top 100 Independent Financial Advisors" rankings since 2007. For more about The MDE Group, visit www.mdegroup.com.