



Potential Time Bomb: What's Your Committee's Appetite for Risk?

UNDERSTANDING HOW YOUR COMMITTEE WILL RESPOND TO NEAR-TERM RISK WILL HELP YOU WIN INVESTING'S LONG-TERM GAME.

When we enter into a new client relationship, one of our first steps is understanding our client's goals and objectives as they relate to the investments for which they have fiduciary oversight. Determining the risk tolerance of the individual committee members who will be making decisions regarding the asset allocation strategy or the investment line-up is critical to this dialogue, as well as gaining an understanding of the risk assumptions that initially went into building the asset allocation strategy or investment menu. In this Informed Sponsor Report, we will discuss the challenges of measuring risk tolerance, how to overcome harmful group psychology when markets get rough, and how volatile equity markets may shape future risk tolerance.

For several decades investment professionals, academics and psychologists have tried to gain a better understanding and methodology for evaluating investor risk tolerance. Dozens of studies have examined characteristics like gender, race, time horizon, socioeconomic background, education and marital status. Over time this research has led to several generalities regarding those willing to take on more risk and those who are not.

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For example, individuals with higher education levels tend to have greater risk tolerances than those with lower education levels. And men tend to take proportionately more risk than women. However, these demographic characteristics only provide a superficial profile of individual risk tolerance and inherent risk perceptions.

The consultant's common approach when analyzing risk tolerance is to have each committee member fill out a questionnaire that is designed to gain a perspective of each member's understanding of the capital markets and their expectations as they are related to risk and return. Generally speaking, the questions rarely reveal true risk tolerance, but more or less help determine how much education will be needed to properly formulate and evaluate the portfolio's asset allocation. Frequently, an asset allocation strategy is already in place so the questionnaire provides feedback that can be used to confirm the committee's understanding of the risks of the current strategy and the potential returns that can be achieved.



Unfortunately, not every committee member has the same definitions or expectations of “risk.” From an investment point of view there are varying degrees of market risk or exposure to capital losses among the different asset classes. But what about the risk of not achieving the desired return needed to fund spending requirements, thereby leaving the portfolio vulnerable to principal erosion? There is the risk of underperformance by underlying investment managers who were selected to obtain exposure to specific styles and strategies. Finally, there is a personal fiduciary risk to committee members for not following an appropriate due diligence process for plan decisions related to the invested assets.

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Ultimately, the committee must understand the fact that any of the above mentioned risks can be managed and even minimized to a large degree, but can never be fully eliminated. It is the role of the consultant to lay the educational groundwork for the committee regarding these risks and how they might impact the portfolio or investment offering. There will have to be a realization that a certain level of market risk will be necessary to achieve higher targeted levels of return. Operational risks must be understood, and policies and processes should be established to minimize them as much as possible. Finally, there is the risk that the group will stray far from the portfolio’s stated goals and objectives in reaction to a recent events rather than sticking to the portfolio’s investment policy. This behavior could put the committee in a difficult position with their board.

A case in point was observed at the end of 2008, as the equity markets shed approximately 40 percent of their value in a few short months. Portfolio allocations became unbalanced as fixed income exposures shot up while equities declined. Individual committee member fears started to infiltrate the group decision-making process and threatened knee-jerk changes to long-term goals and objectives. In essence, psychological risk tolerance was changing on the fly and hindering prudent decision-making.

It’s this type of environment where a good consultant can prove his or her worth. Armed with probably the most important fiduciary document at their disposal – the investment policy statement or IPS – the consultant can rationalize the discussion and bring clarity to the decision-making process. A properly drafted IPS should clearly state the investment goals for the portfolio or investment menu and the process and conditions that would require rebalancing or replacement. It also provides the basis to discuss the asset allocation strategy, as it relates to the organization’s risk and return goals. It is important that the emotional component be removed from decisions that can impact the strategy in the near term.

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The jury is still out as to how the recent “bear” market will impact committee member appetite for risk going forward, but we are already seeing committees re-evaluating their strategies to determine if non-traditional diversifiers or alternative asset exposures should be



added or increased to reduce future downside risks and/or to improve the overall return picture. Additionally, we are coming to the end of a decade that has produced two severe “bear” market events; even with a strong finish in 2010, we can almost certainly conclude that the recent decade will be one of the worst that equity investors have ever experienced. This will undoubtedly lead many to reconsider traditional levels of equity exposure and its overall role within the portfolio.

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Evaluating “true” risk tolerance is a complicated process and in most cases individual risk tolerance is heavily influenced by the current market and economic environment. Although the science of understanding how individual investors behave is ongoing, risk assessment remains as much an art as it is a science. Then consider that a committee is made up of a dynamic group of people with varying levels of investment understanding and a wide range of risk-related experience and the task of keeping the committee “on task” becomes extremely difficult. Therefore, it is imperative that the consultant continually educate and inform the committee as to their duties while enhancing their overall understanding of the variety of risks that they may encounter during their tenure.

For more than 20 years the professionals at Bidart & Ross, Inc., have helped fiduciary committees maintain their focus – in good markets and bad. For more on Bidart & Ross’ completely independent brand of fiduciary consultancy, visit www.Bidart-Ross.com, or contact a firm principal directly at:

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