Risk Tolerance for Investment Committees

RiskBridge Advisors

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ABOUT RISKBRIDGE

RiskBridge Advisors, LLC ("RiskBridge") is an independent, full service investment office focused on helping investors achieve extraordinary outcomes. We offer discretionary portfolio solutions and risk- aware investment advice to institutional investors and individuals.

Our sole purpose is to serve those who serve others. We aspire to help our clients grow their businesses, find more cures, award more scholarships, deliver more grants, offer more community services, and build secure retirements and resilient legacies.

RISK TOLERANCE FOR INSTITUTIONS

When framing investment policy for institutions, we believe one of the most critical considerations is the risk tolerance of an organization's board of trustees or investment committee.

Too often, investment policies treat risk as an afterthought. Risk is referenced conceptually, using vague language that refers to risk being held to an "acceptable" or "prudent" level. Our view is that many policies fail to address the specific risk incurred to achieve the investment goals.

This paper is intended for trustees and investment committee members who want to:

- Understand their own level of risk tolerance;
- Take steps to align risk in their policy and portfolio appropriate for the institution's unique nature; and
- Strive to achieve balance between risk and return.

To achieve those objectives, organizations' boards or investment committees should explore processes that yield sufficient self-knowledge to enable these fiduciary bodies to make better governance and portfolio decisions.

Definitions of Relevant Risks

Boards are commonly focused on investment risks. However, fiduciaries are also responsible for exploring and understanding other risks to the organization, including:

Enterprise Risk

Strategic risks impacting revenue, costs, and the sponsoring organization's balance sheet

Operational Risk

Risks to operational integrity, including cyber risk and counterparty risk

Reputation Risk

An inability to keep up with competitors

Investment Risk

Risk of permanent loss, equity risk, credit risk, interest rate risk, liquidity risk

Risk Aversion

A board's reluctance to accept reasonable levels of risk. It is possible and much more common for endowments to fail due to the misallocation of risk

Risk Tolerance

A board's willingness to accept large but temporary losses in portfolio values to pursue potentially higher long-term returns in support of the organization's goals

Anchoring

When board or committee members stick to misguided assumptions or biases about future returns, which skew investment decision making

FACTORS SHAPING RISK TOLERANCE

A fiduciary body should consider a range of factors in the process of obtaining a better understanding of its risk tolerance.

- Board or investment committee composition
- Group dynamics
- Institutional behaviors
- Time horizon
- Information overload
- The institution's existing investment policy
- Comprehensive risks

BOARD AND INVESTMENT COMMITTEE COMPOSITION

The composition and leadership of the board and investment committee offer another opportunity to assess risk tolerance. In the case of the investment committee, we believe it is best to bring a mix of backgrounds, skills, and cognitive diversity to the group while having an experienced investor as chair.

Boards and investment committees benefit from a culture of intellectual curiosity that leads to thoughtful committee deliberations and decision-making. While members with in-depth experience in investment management are essential to the functioning of an investment committee, we believe an investment committee should have members who understand other subjects and bring diverse backgrounds and perspectives to the table.

In addition, the practical orientation of incoming committee members is very important. One helpful leadership technique is for the chair to emphasize the value of all the group members and guide the discussion to balance participation, managing and monitoring the quality of the group process as it unfolds over time.

The chair must manage information-sharing as an active process, developing a thorough process of presenting and weighing conflicting evidence before a decision. The chair can help focus the committee on the more significant issues aligned with the long-term nature of the assets and that ultimately can shape successful outcomes.

GROUP DYNAMICS

Emotional, psychological, and behavioral factors enter prominently into investment decision-making. The field of behavioral investing, pioneered by Daniel Kahneman of Princeton and the late Amos Tversky of Stanford, has shed considerable light on the committee process.

It can be challenging for investment committee members to see themselves, their group's procedures, and their decisions entirely objectively. As author and writer Jason Zweig observed in a 2009 article about the financial crisis appearing in The Wall Street Journal, many billions of dollars "were lost by smart people trying to do good, honest work on behalf of others—usually as part of a committee."

INSTITUTIONAL BEHAVIORS

As investment markets fluctuate, committee members and trustees may naturally feel various emotions, from pride and confidence to shame and fear. During a market downturn, the desire to minimize losses in the short term can lead to poorly informed decisions that may negatively affect the portfolio's value. In the emotion of the moment, it may seem better to act than to sit by and watch asset values fall.

As a result, trustees have looked back after a severe market downturn and wondered how their "risk management system" could have failed them. With the clarity of hindsight, they realize that the risk in their portfolio exceeded the intended level, as a set of investment policies that once looked safe suddenly became a source of uncertainty.

Research shows flawed decisions are most common at market tops and bottoms when investors overreact (Payne, 2009). Investment committees are social groups of individuals influenced by the market environment, others around the table, or their peers. The pressure to conform may make investment committees vulnerable to emotionally charged reactions versus rational responses. Veering off the strategic path can compound the problem when standing pat may well be the better option.

TIME HORIZON

Thoughtful fiduciaries continue to believe that the most reliable way to measure the efficacy of a plan is over a full market cycle or longer. Most institutions consider their assets perpetual. We believe the proper time horizon for an investment committee is at least 10 to 15 years.

In times of crisis, however, investment horizons can become compressed as events expected to unfold over a long period can instead occur in a matter of days. Human nature is to react or "do something" in times of crisis. Experience shows that the time frame for investment decisions can become dangerously short term in such circumstances.

INFORMATION OVERLOAD

Boards and investment committees have never had more freedom of choice and access to information, but the sheer volume of data, information, and jargon can be overwhelming for many fiduciaries. In our view, information overload makes investing more complex than is necessary.

People's time, attention, and ability to focus are scarce resources. The consequence of information overload can include oversimplification or avoidance of decision-making. RiskBridge encourages boards and investment committees to focus on what they can control, including the amount of risk taken with the assets and their emotions.

RISK-BASED SOLUTIONS FOR INVESTMENT COMMITTEES

INVESTMENT POLICY REVIEW

Most institutions have an investment policy statement that addresses investment objectives, asset allocation, liquidity, and rebalancing. Asset allocation and rebalancing, two central building blocks of the investment policy statement, play a crucial role in risk management. We believe asset allocation is insufficiently valued as a determinant of investment success by many fiduciaries, particularly in comparison with manager selection. Analysis suggests that over 90 percent of the variation in a portfolio's return is attributable to asset allocation decisions (Brinson, 1986). Rebalancing is a disciplined and effective process to help reduce risk over time.

Yet even though these two factors are recognized as being of the highest importance, evidence shows that boards consistently devote much more time to activities such as attempting to time the market and hiring and firing investment managers, which add little and may even be destructive to value.

It is also important that the investment policy embody the board's qualitative and quantitative attitudes toward risk, which can vary significantly from member to member. A strong investment policy will define the risks that the committee and staff believe are most relevant.

RISK TOLERANCE QUESTIONNAIRES

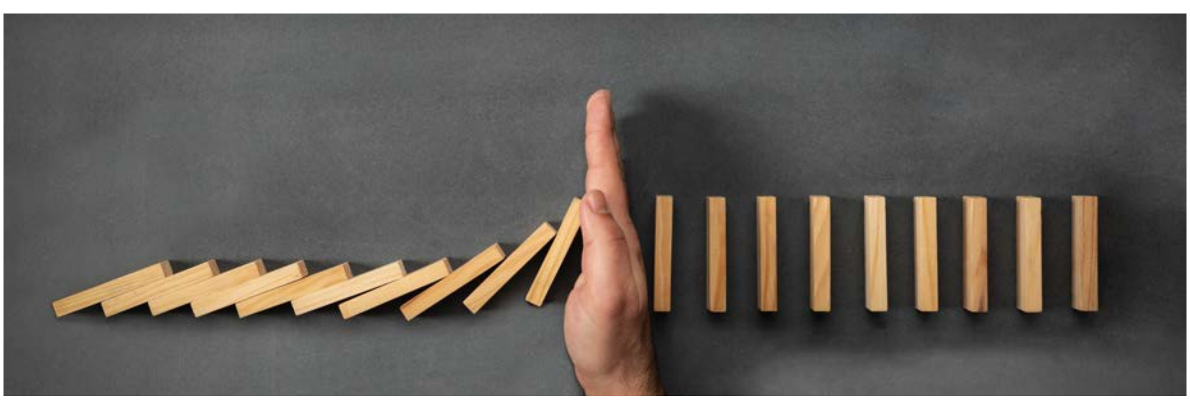
Risk tolerance questionnaires may be used to help fiduciaries attempt to gauge their risk appetite. They tend to yield a psychological snapshot of attitudes towards risk at a given moment. Instead, we believe it is essential for a risk tolerance questionnaire to accurately reflect the board's sentiment based on consistent risk management principles that reflect a thoughtfully considered approach that can be applied over a longer period.

COMPREHENSIVE RISK ASSESSMENT

Fiduciaries may find it helpful to identify and prioritize likely risk events and their impact on the institution. Trustees and committee members should ask themselves how the institution could respond to "risk events" and rank them in terms of the likelihood and severity of the impact on the mission. For example:

- What is the risk to the sponsoring entity of an external event adversely impacting revenues, expenses, or operational integrity?
- What is the impact of a 20 percent decline in portfolio value?
- Other risks such as an unexpected need for liquidity could also be analyzed. Members should ask themselves how the institution could respond to such events, rank them in terms of their perceived probability, and assess the damage they could cause.

A similar exercise that many commercial institutions have found helpful is to conduct a "table-top" thought exercise in which a hypothetical damaging event is assumed to have occurred, and the group works backward to ascertain how the event could have come to pass. This process can foster discussion of institutional weaknesses or gaps that might be difficult to see in prospect but that become all too clear in hindsight.



CONCLUSION

RiskBridge believes institutional investors are better prepared for uncertainty and complexity when their boards and investment committees consider a range of risk factors. Investment performance is important, but the true value an outsourced chief investment officer (OCIO) can offer is a deep understanding of the quantity and types of risk required to perform.

Organizations should keep this in mind as they seek to be more effective, enhance their governance and fiduciary practices, and select trusted partners to help navigate an increasingly complex landscape.

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