

## Let's talk about risk

– Stephen Nguyen, CFA

Risk is part of everyday life. It exists in various forms and as a result we are constantly making decisions by assessing the risks involved. We effectively act as our own risk manager whether we realise it or not. Risk management is a crucial element of investment management and it has certainly become an even more integral function for the industry post the Global Financial Crisis (GFC). The GFC highlighted the limitations of relying only on traditional quantitative risk models. With that in mind, how should we approach the role of risk management today?

Risk models are exposed to a certain level of reliance on historical data. In the past there has arguably been an over-reliance on backward looking analysis. Hence it is critical that forward views are incorporated, along with stress testing (what happens if we have a repeat of past crisis conditions) and scenario analysis (what could happen given pre-determined conditions, and what we might expect the portfolio to do in this scenario). Even the simple acknowledgement that correlations can be unstable in the short term is another important risk analysis – therefore hypothetical scenario analysis can provide freedom to challenge historical assumptions. Much like performance, the past is not a guide to the future when measuring or forecasting diversification.

Multi asset managers are constantly having to trade off expected risk and return in order to deliver the outcome for their clients. Controlling the overall level of risk over time will deliver a more palatable journey for investors but in order to achieve this, risk and return need to be clearly understood and effectively managed. For example, a 50%/50% equity/bond allocation does not translate to equal risk contribution as the equity allocation will dominate the risk because equities are a lot more volatile than bonds. An important concept is understanding marginal contribution to risk – as this decomposes risk

to a more granular level and allows portfolio managers to understand the risk sensitivities of every position in the portfolio.

Effective risk management should not be a policing role, which heavily emphasises the ex post (after the event) analysis of portfolios versus outcomes or benchmarks. Instead risk management should be incorporated into the investment process, as investment risk is optimally managed when a risk expert works alongside the portfolio manager. Risk managers can shine considerable light on a portfolio ex ante (before the event), and therefore help portfolio managers to make better informed investment decisions.

The risk function should not necessarily be solely about limiting risk-taking, as you need to take risk to achieve the desired outcome. More importantly risk managers should work with portfolio managers to establish and understand the distinction between compensated and non-compensated risk. Both qualitative and quantitative elements should be incorporated in order to avoid biases. Quantitative modeling mitigates portfolio manager behavioral biases. But you still need qualitative inputs in order to minimise model risk and avoid becoming beholden to historical data and relationships which may not persist, or perhaps do not exist; correlation does not imply causation. Quantitative models are not an exact science, but it nevertheless provides a useful approximation to reality.

Taken together, these insights give us a much more complete tool kit and bring risk management out of the wilderness and into much greater focus in firms like ours. We are committed to the journey as well as the outcome. Risk managers are not always there to spoil the party. On the contrary, without them there may be no party at all.

## The Marketplace

- US Federal Reserve cut its rate by 25 basis points
- Donald Trump announced a 10% tariff on \$300bn of Chinese goods
- Brent crude fell 4.7%, ending the week at \$60.5 per barrel
- Gold prices were flat ending the week at \$1419.1 an ounce

## Market Focus

### US

- Following the Federal Reserve rate cut, equities fell, and the yield curve flattened with the dollar strengthening.
- A poor MNI Chicago PMI for July helped justify the Federal Reserve's rate cut as the index fell to 44.4 (against 51.0 expected), the lowest level since December 2015.
- The Conference Board's consumer confidence index result for July was 135.7, significantly above the 125 that was expected, and the highest level in 8 months.
- Following the negative trade talks and worsening outlook in the US, equities fell 2.4%.
- US treasuries gained 1.2% during the week, adding to their strong year to date performance of 6.2%.

### Europe

- Growth in the eurozone economy was only 0.2% over the last quarter, half the 0.4% that was posted in the first three months of the year. Inflation also fell from 1.3% in June to 1.1% in July.

- The final European July manufacturing PMIs were released in the past week, showing poor momentum across the continent.
- European equities fell heavily on Tuesday and Friday following US president Donald Trump's continuing trade war with China, causing equities to end the week down by 0.7%.

### UK

- The Bank of England maintained its base rate at 0.75%, as well as cutting their growth outlook for the UK.
- Consumer credit growth continued its fall to 5.5% year-on-year in June, its lowest level since April 2014, although mortgage approvals were stronger than expected at 66.4k in June.
- The UK government has doubled spending to £4.2bn in preparation for a no-deal Brexit as Boris Johnson further signals his intention to leave the EU without a deal if necessary.
- The UK large-cap index returned 0.4% on the week, helped by a steep -1.9% fall in sterling due to the rising no-deal Brexit possibility.
- UK gilts returned 1.0%, while investment grade bonds returned 0.5%.

### Asia/Rest of The World

- China's manufacturing PMI for July was reported at 49.7, above expectations but still in contractionary territory.
- The Bank of Japan voted in favour for keeping short-term interest rates at -0.1% and long-term rates around 0%.

Asset Class/Region	Currency	Currency returns			
		Week ending 2 Aug 2019	Month to date	YTD 2019	12 months
<b>Developed Market Equities</b>					
United States	USD	-2.4%	-0.9%	18.8%	6.0%
United Kingdom	GBP	0.4%	0.0%	15.3%	4.4%
Continental Europe	EUR	-0.7%	0.6%	18.3%	3.7%
Japan	JPY	-0.3%	0.1%	6.3%	-8.4%
Asia Pacific (ex Japan)	USD	-2.3%	-1.0%	9.6%	-0.7%
Australia	AUD	-0.1%	-0.3%	22.8%	13.6%
Global	USD	-1.9%	-0.7%	16.8%	3.2%
<b>Emerging markets equities</b>					
Emerging Europe	USD	-1.0%	-1.6%	18.9%	13.0%
Emerging Asia	USD	-2.5%	-1.1%	6.8%	-3.8%
Emerging Latin America	USD	-2.2%	-1.7%	10.9%	7.2%
BRICs	USD	-2.6%	-1.3%	11.3%	2.1%
MENA countries	USD	-1.4%	-0.7%	9.4%	4.9%
South Africa	USD	-1.5%	-1.1%	7.0%	-5.3%
India	USD	-3.5%	-2.1%	2.3%	-2.4%
Global emerging markets	USD	-2.3%	-1.2%	7.9%	-1.6%
<b>Bonds</b>					
US Treasuries	USD	1.2%	0.8%	6.2%	8.9%
US Treasuries (inflation protected)	USD	0.7%	0.4%	7.2%	6.4%
US Corporate (investment grade)	USD	1.0%	0.7%	11.3%	11.4%
US High Yield	USD	-0.1%	-0.1%	10.5%	6.8%
UK Gilts	GBP	1.0%	0.6%	8.0%	9.1%
UK Corporate (investment grade)	GBP	0.5%	0.3%	9.8%	9.4%
Euro Government Bonds	EUR	0.7%	0.1%	7.9%	9.2%
Euro Corporate (investment grade)	EUR	0.2%	0.0%	6.9%	6.0%
Euro High Yield	EUR	-0.2%	0.0%	8.6%	4.8%
Japanese Government	JPY	-0.1%	-0.2%	2.8%	4.2%
Australian Government	AUD	0.2%	-0.2%	8.7%	12.8%
Global Government Bonds	USD	0.5%	0.2%	5.1%	6.6%
Global Bonds	USD	0.4%	0.1%	5.5%	6.4%
Global Convertible Bonds	USD	-0.7%	-0.5%	7.3%	2.6%
Emerging Market Bonds	USD	0.0%	-0.1%	11.6%	11.0%

Asset Class/Region	Currency	Currency returns			
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<b>Property</b>					
US Property Securities	USD	0.4%	0.0%	18.4%	9.9%
Australian Property Securities	AUD	-0.4%	0.5%	20.1%	16.1%
Asia Property Securities	USD	-2.6%	-1.0%	8.3%	7.5%
Global Property Securities	USD	-1.0%	-0.4%	14.6%	7.5%
<b>Currencies</b>					
Euro	USD	-0.5%	-0.5%	-3.4%	-4.7%
UK Pound Sterling	USD	-1.9%	-0.6%	-4.7%	-6.8%
Japanese Yen	USD	0.5%	0.4%	1.4%	3.2%
Australian Dollar	USD	-0.6%	-0.2%	-2.5%	-7.0%
South African Rand	USD	-1.4%	-2.3%	-0.8%	-7.8%
Swiss Franc	USD	0.1%	-0.3%	-1.0%	0.2%
Chinese Yuan	USD	-0.3%	-0.2%	-0.3%	-0.8%
<b>Commodities &amp; Alternatives</b>					
Commodities	USD	-2.6%	-3.2%	3.3%	-8.4%
Agricultural Commodities	USD	-3.0%	-1.2%	-6.3%	-12.5%
Oil	USD	-4.7%	-7.2%	12.5%	-17.6%
Gold	USD	0.0%	-0.4%	10.7%	16.9%
Hedge funds	USD	0.0%	0.0%	5.0%	-1.0%

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