Funston Advisory Services LLC

5 Strategic Risk and the Role of the Board

By Rick Funston and Randy Miller, June 12, 2014

Introduction

This article focuses on strategic risks and the role of the board. We define risk as the potential for failure that results in loss, harm or missed opportunity and includes the risk of inaction. Conventional risk management often defines operational risk as events or conditions that may negatively affect the organization's ability to achieve an objective or creates unwanted variability caused by people, processes, systems or external factors. These are the risks **TO** the strategy.

But what if the organization's strategy and objectives are wrong? These are the risks **OF** the strategy itself. The biggest source of strategic risk and opportunity for a public retirement system lies in the choices the board makes regarding asset allocation. Asset allocation decisions are subjective. There is no hard science. There is no prediction. It is a judgment call. So how do fiduciaries make the best decision under the circumstances?

Such strategic decisions are based on a set of underlying assumptions. In the past, those assumptions were often implicit e.g., the national price of housing in the U.S. will continue to rise indefinitely. The consequences of failing to challenge this one assumption prior to 2008 led to catastrophic consequences from which the country is just now recovering.

Every strategy, plan or forecast is based on a set of assumptions. It is important that these assumptions be made explicit to guide board decision-making and to enable them to be challenged in light of changing market conditions. The time frame for these assumptions also ought to be made explicit as well as any correlations between the assumptions.

Making underlying assumptions explicit is one of the hardest things for a board to do because they are often imbedded in conventional belief systems much as a fish doesn't know it is

swimming in water. Nonetheless, a growing number of fiduciaries are beginning to articulate their assumptions in the form of investment beliefs.

Examples of Potential Public Pension Fund Assumptions

Assumptions drive investment strategies and organization. There are two major types of assumptions in a public retirement system: market assumptions and investing assumptions. Investment theories, strategies and organization are also derived from beliefs about the market. These are important inter-relationships that need to be understood and the time horizon should also be made clear. A framework for the formulation of investment beliefs and assumptions will be discussed in a separate article but several examples of each are shown below:

Market Assumptions [i]

1. The risk-free rate of return is projected to average 3% annually over the next 10 years.
2. Fixed income net excess returns compared to a risk-free rate are expected to average 2.5% per year.
3. Net excess returns for domestic stocks are expected to average 5.0% per year.
4. Hedge funds have the lowest volatility of any asset class and a lower correlation with public equities than private equity.
5. Private market investments offer an additional liquidity premium to patient investors.

Investing Assumptions

1. Relatively inefficient markets such as emerging market public equities and emerging market debt offer the chance to capture positive alpha through active management.
2. Net risk-adjusted returns increase with the scale of the investment in private markets due to improved fee leverage and investing efficiencies.
3. Internal management of assets is desirable when the internal management costs are clearly lower than external manager fees, the capabilities of the internal staff are competitive with external managers, and the infrastructure (trading systems, risk management systems, business continuity capabilities, etc.) is capable of effectively supporting the internal management team.
4. Liquidity should be maintained at a level to avoid distressed selling of illiquid assets during a market downturn.

The Importance of Challenging Assumptions

Once assumptions have been made explicit, they can and should be periodically challenged by the board and executive. Several examples are provided below. Given that one of the key advantages of retirement system is the ability to invest for the long-term, the investment horizon needs to be defined as part of the market assumptions.

MARKET ASSUMPTIONS	CHALLENGE
The risk-free rate of return is projected to average 3% annually over the next 10 years.	The risk-free rate of return DOES NOT average 3% annually over the next 10 years.
Fixed income net excess returns compared to a risk-free rate are expected to average 2.5% per year.	Fixed income net excess returns compared to a risk-free rate DO NOT average 2.5% per year.
Net excess returns for domestic stocks are expected to average 5.0% per year.	Net excess returns for domestic stocks DO NOT average 5.0% per year.
Hedge funds have the lowest volatility of any asset class and a lower correlation with public equities than private equity.	Hedge funds DO NOT have the lowest volatility of any asset class and a lower correlation with public equities than private equity.
Private market investments offer an additional liquidity premium to patient investors.	Private market investments DO NOT offer an additional liquidity premium to patient investors.

INVESTING ASSUMPTIONS	CHALLENGE
Relatively inefficient markets such as emerging market public equities and emerging market debt offer the chance to capture positive alpha through active management.	Relatively inefficient markets such as emerging market public equities and emerging market debt DO NOT offer the chance to capture positive alpha through active management.
Net risk-adjusted returns increase with the scale of the investment in private markets due to improved fee leverage and investing efficiencies.	Net risk-adjusted returns DO NOT increase with the scale of the investment in private markets due to improved fee leverage and investing efficiencies.
Internal management of assets is desirable when the internal management costs are clearly lower than external manager fees, the capabilities of the internal staff are competitive with external managers, and the infrastructure (trading systems, risk management systems, business continuity capabilities, etc.) is capable of effectively supporting the internal management team.	Internal management of assets is NOT desirable when the internal management costs are NOT clearly lower than external manager fees, the capabilities of the internal staff are NOT competitive with external managers, and the infrastructure (trading systems, risk management systems, business continuity capabilities, etc.) is NOT capable of effectively supporting the internal management team.
Liquidity should be maintained at a level to avoid distressed selling of illiquid assets during a market downturn.	Liquidity should NOT be maintained at a level to avoid distressed selling of illiquid assets during a market downturn.
Fund investment staff compensation should be aligned with effective long-term execution of the selected strategic asset allocation.	Fund investment staff compensation SHOULD NOT be aligned with effective long-term execution of the selected strategic asset allocation.

Defining Risk Appetite and Tolerance

Risk appetite and tolerance are directly related to investment assumptions. Without an explicit statement of investment assumptions, it is very difficult for the board to arrive at a meaningful statement of risk appetite and tolerance. Risk appetite is the level of risk an organization is prepared to accept after mitigation. Risk tolerance is the amount of risk an organization is actually capable of tolerating. In challenging each investment assumption, ask "how much variability in these assumptions is acceptable? What would be the consequences if the

assumption proved false? Is this acceptable?" For example, challenging the market assumptions, leads to questions and insights regarding risk appetite and tolerance:

MARKET ASSUMPTIONS CHALLENGE	RISK APPETITE / TOLERANCE
The risk-free rate of return DOES NOT average 3% annually over the next 10 years.	Is it acceptable if the return is less than 3%? How much less? What would be the impact if it was 1 or 2%? Can you afford that loss? What if the risk-free return is greater than 3%?
Fixed income net excess returns compared to a risk-free rate DO NOT average 2.5% per year.	Is it acceptable if fixed income net excess returns compared to a risk free rate are less than 2.5%? How much less? For how many years? Can you afford the consequences? What if fixed income net returns are greater than 2.5% per year?
Net excess returns for domestic stocks DO NOT average 5.0% per year.	Is it acceptable, if net excess returns for domestic stocks are less than 5% on average per year? How much less? For how many years? Can you afford the consequences? What if domestic stock net returns are greater than 5% per year?
Hedge funds DO NOT have the lowest volatility of any asset class and a lower correlation with public equities than private equity.	Is it acceptable, if hedge funds do not have the lowest volatility and a lower correlation with public equities than private equity? What level of volatility and correlation is acceptable? For how many years? Can you afford the consequences?
Private market investments DO NOT offer an additional liquidity premium to patient investors.	Is it acceptable, if private market investments do not offer an additional liquidity premium? How much less? For how long? Can you afford the consequences?

By taking each investment assumption and challenging it, the board can then ask meaningful questions to determine their risk appetite and tolerance.

Signal Detection and Pattern Recognition

Once the board has made its investment assumptions explicit and defined the system's risk appetite and tolerances, the stage has been set to look for signals as to whether these thresholds are being maintained or about to be exceeded, and what the patterns of threat or opportunity might look like and the response options to those various patterns.

This allows for a continuing constructive dialogue between the board and th executive about whether these investment assumptions remain valid or may need to change.

Conclusion

Understanding and managing strategic risk is one of a fiduciary's primary responsibilities and asset allocation is the biggest strategic risk for a public pension fund. Fiduciaries need to focus more of their time on strategic vs. operational matters. Clarifying investment assumptions is an evolving but critical piece in improving fiduciaries' ability to understand and manage strategic risks. If assumptions are incorrect, asset allocation will be sub-optimal. Making market and investing assumptions explicit is an important first step in a strategic, risk intelligent dialogue about acceptable vs. unacceptable risk and in the formulation of practical definitions of risk appetite and tolerance.

About the authors. Rick Funston is the Managing Partner of Funston Advisory Services LLC which specializes in governance, strategy, and risk intelligence. Rick was formerly the National Practice Leader for Deloitte's Governance and Risk Oversight Services. He is the principal author of 'Surviving and Thriving in Uncertainty: Creating the Risk intelligent Enterprise" Wiley and Sons, 2010.

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[i] Some market assumptions are adapted from *Investment Beliefs of Endowments*, Andrew Ang, Columbia Business School and NBER, Andres Ayala, Columbia Business School, William N. Goetzmann, Yale School of Management and NBER, April 1, 2014

