THIS IS THE FIRST INSTALLMENT OF A TWO-PART SERIES

# Why risk management now?

Samuel Won, founder/managing director of Global Risk Management Advisors looks at the recent changes in risk management

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It has been over five years since the start of the largest financial crisis since the Great Depression. Given the spectacular failures of many major financial institutions and the huge losses suffered by almost all investors, ranging from institutional to "mom and pop", the term "risk management" is now a part of everyone's lexicon. Why are institutional investors – such as endowments, foundations, pension funds and family offices – in particular beginning to perform more formal risk management as it relates to their investment portfolios? What is driving this change? Below I present some observations on this topic based on the experience I've had in advising institutional investors about risk.

We have found that endowments, foundations, pension funds and family offices have come to realize they can no longer ignore the significant fiduciary risks associated with not having a formal approach to risk management of their investment portfolios. In addition, institutional investors are beginning to follow the "leaders of the herd" such as Harvard, Stanford and CALPERS, which already take a more formal approach to investment risk management. Some institutional investors have realized that their investment advisors and asset managers do not provide them with either formal or sufficient risk management services. Also, many institutional investors are starting to understand that their investment advisers have a conflict of interest because of their role in asset allocation and manager selection, and, therefore, cannot provide the independent perspective nor risk management subject matter experience that is essential to provide these institutions with true and robust risk management.

## WHAT ARE THE RISK MANAGEMENT CHALLENGES FOR INSTITUTIONAL INVESTORS?

Institutions such as endowments, foundations, pensions and family offices, regardless of size, tend to confront many of the same challenges with regards to risk management. These challenges include:

- **Resources:** the vast majority of these institutions do not have the necessary resources – staff, systems or subject matter expertise – to do substantive risk management.
- **Risk Measurement, Aggregation and Monitoring:** most institutional investors are flying blind because they lack capabilities to measure, monitor and report the investment risks (market, credit and liquidity risks) in their liquid securities as well in their illiquid investments such as real estate.
- **Education/Training of Staff, Boards and Investment Committees**: the majority of institutional investors want to educate and train their staff, board and investment committee on risk management and on governance of risk and investment management, but lack the in-house expertise to do so.
- **Alternative Investments**: given today's low yield environment, institutional investors are increasing their allocation to alternative investments. As a result, they are finding that their traditional methods of evaluating and monitoring long-only investments do not translate well to their alternative investment portfolios because alternative investments have much more complexity and idiosyncratic risk.
- **Tail Risk Hedging, Risk Overlay and Risk-based Asset Allocation**: many institutions are interested in exploring and/or implementing new techniques for investing and risk mitigation such as tail-risk hedging, risk overlay and risk-based asset allocation. However, these institutions are confused, frustrated and unable to proceed in developing or implementing such techniques because they are not able to assess the impact this risk mitigation or overlay would have incrementally or in aggregate on the portfolio's risks (market, credit and liquidity risks across both liquid and illiquid investments).

In the next part of this series on risk management challenges faced by institutional investors, I will discuss the essential elements that are necessary for endowments, foundations, pensions and family office for a sound and sustainable program. In addition, I will elaborate on the reasons why risk management should be integrated into an institution's investment process so that it is cohesive and truly "one process." ■

*Samuel K. Won is the founder/managing director of Global Risk Management Advisors, the leading independent risk management advisory firm that provides institutional-quality risk management advisory and implementation services to asset managers and institutional investors. Won has more than 25 years of experience in risk analysis and reporting, risk infrastructure implementation, risk strategy, trading/capital markets and portfolio investment management at major global financial institutions, asset management firms and the government.*