RISK PROFESSIONAL

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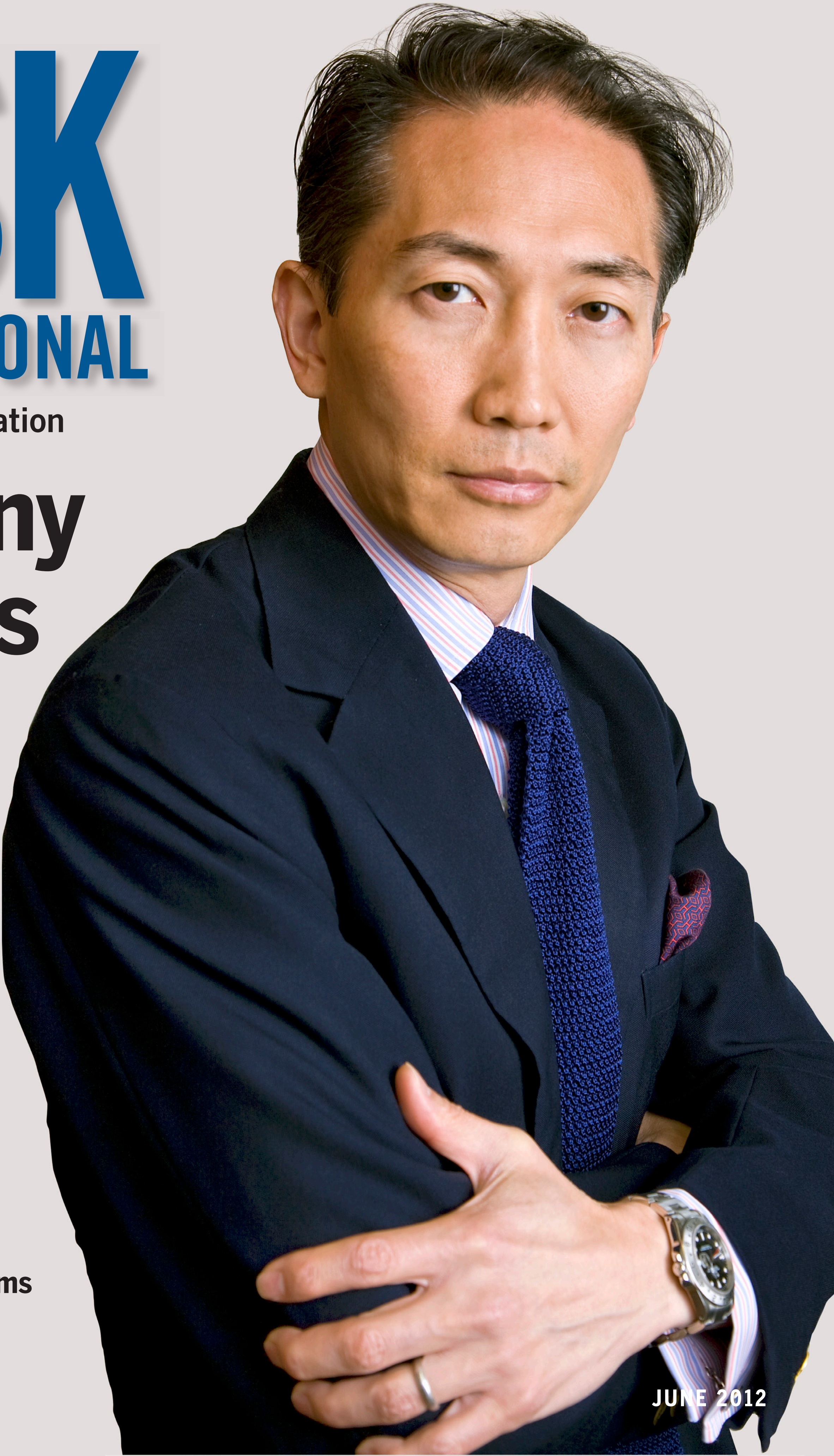

Company Of CROs

Perceiving a talent void, Samuel Won and his team of investment industry experts deliver risk management as a service

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Expertise as a Service

Risk assessments are ample in the investment world, but risk management is lagging, say the veteran CROs behind advisory firm GRMA. Their mantra: Institutional-quality risk management.

By Dawn Kissi

If there is any doubt that risk management expertise is a hot commodity, then a visit with Samuel Won will dispel it in a hurry. Won is managing director of Global Risk Management Advisors, a firm he founded in 2010 after more than 20 years in risk management, capital markets and other financial industry positions including chief risk officer of Brencourt Advisors and Ospraie Management and head of investment risk management at Citigroup Alternative Investments.

No longer excited by the prospect of managing risk solely for a major hedge fund or university endowment, Won has gone his own way to be everything a CRO can be – and more – for any and all comers, be they asset managers, asset owners, corporations, prime brokerages, fund administrators or other service providers.

New York-based GRMA describes itself as "the leading risk and investment management advisory firm," and it is literally built around CROs and the principles and practices of risk management. Its "institutional-quality solution" encompasses risk reporting, risk measurement, due diligence, infrastructure and processes, risk audits, investor relations and communications. Clients' assets under management have ranged from $35 million to $19 billion.

The hard truth, says Won, is that robust risk systems and processes are often lacking, leaving asset managers and investors vulnerable to uncertain and volatile markets.

"There is a lot of risk measurement, but not risk management being done," he observes, explaining GRMA's holistic approach and dedication to best practices. "We learned from the financial crisis, but a lot still needs to be done. My team and I work to guide firms through market volatility and investor and regulatory scrutiny." Most failures in the crisis were "caused by lack of or faulty risk management, and more needs to be done."

Won leads a team of six principals who include managing director Timothy Wilson, who was CRO of the Caxton As-

Photographs by Leslie Jean-Bart

Taking account of model weakness is one aspect of the art of risk management, says GRMA senior principal Timothy Wilson.

CRO INTERVIEW

sociates hedge funds from 2003 to 2011 and held risk-related positions at Morgan Stanley for nearly 10 years before that; chief operating officer M. Christian Saxman, co-founder and former CFO of digital products start-up CE Interactive; and senior adviser Ken Shoji, former chief investment and risk officer of HedgeMark Advisors.

Won has a BA degree from Northwestern University, attended the Dartmouth Tuck School of Business and earned a master's in international finance and economic policy management from Columbia University. He has advised major financial regulatory agencies in the U.S. and U.K.

He was joined in this dual interview by GRMA senior principal Wilson, who has a bachelor's degree in engineering from Harvard University, did doctoral studies in economics at Stanford University and was founding chairman of the Managed Funds Association's CRO Forum.

What motivated you to launch GRMA?

SAMUEL WON: I felt there was a significant void in risk management. Most funds and institutional investors were not doing any kind of formal risk management, and this continues to be the case. Even today, four years after the biggest global financial crisis of the modern era began, most institutions do not have much in the way of formal and institutional-quality risk management. Specifically, most lack the framework, infrastructure, processes, controls and governance for risk management. In founding GRMA, I had three principal goals in mind:

• Provide asset managers and investors with complete and institutional-quality programs that encompass all of the key facets of sound risk management, including advisory and implementation services for risk framework, risk infrastructure, risk management processes, controls and governance.

• Leverage my extensive experience gained from the sell side, buy side and within government to assemble a team of leading and seasoned risk professionals that would provide asset managers and institutional investors with a holistic solution, delivered in the most cost-efficient manner.

• Work with both of our major client silos – asset managers and institutional investors – to improve risk transparency to their constituencies and all parties they are accountable to and for.

How do you differentiate your firm from others?

WON: No other firm that we are aware of provides complete and institutional-quality risk management programs to asset managers and institutional investors as a managed service. We work with firms that have no risk management, as well as some that have a risk function. There are companies that sell software licenses for risk models and calculation engines. Even around the risk software, these risk analytic firms do not provide formal consulting services to support their software. Meanwhile, the consulting arms of the "Big Four" focus primarily on supporting some of the larger financial institutions on issues such as Basel III, economic capital and Sarbanes-Oxley compliance. Our approach is holistic and institutional-quality, and we provide a managed service that is the most cost-effective solution for complete risk management.

What is your definition of risk management?

WON: Many people mistakenly equate risk measurement with risk management. Risk measurement is really about quantifying the risks associated with a portfolio and/or enterprise. Regarding an investment portfolio, generally it means trying to estimate the market, credit and liquidity risks in the portfolio. In contrast, risk management is what you do once you have identified and measured those risks. Risk management at its core is about process, strategy and consistency. We carefully advise our clients to have sound, repeatable and sustainable processes that are a clear extension of a well-thought-out risk management framework. That means, for example, treating risk management as an input into decision-making relating to asset allocation and hedging. Unfortunately, we find that many leading asset managers and institutional investors try to deal with risk management issues as an output of the investment process, in reaction to adverse events in their portfolio.

How do you take clients through the process?

TIMOTHY WILSON: Sam and I co-head GRMA's asset manager practice. This allows a wide range of funds to access independent, institutional-quality risk management methods that have previously been available only to the select few hedge funds that were willing and able to pay the high cost of developing a really robust in-house risk function.

First, GRMA works with clients to develop a risk management policy framework, customized for each client. Its various elements typically include developing written risk policies and procedures; establishing a risk committee and setting forth its responsibilities; devising a risk limit/guideline structure appropriate to the fund's trading; etc.

Second, risk measurement: We design and implement processes to execute sophisticated daily risk calculations suitable for a client fund's portfolio. Normally, implementing a sophisticated risk calculation engine takes six months to a year. We can do it much faster thanks to our experience and already developed software "pipes." The risk calculations generally include some combination of risk-adjusted exposure metrics, value-at-risk, stress tests and scenario analysis.

Third, we develop and put in place useful aggregations of risk information. There is a subtle art to determining for a given portfolio the best dimensions along which to summarize the risk in a set of exposures. Having sliced and diced risk in a wide range of portfolios, GRMA, in dialogue with portfolio managers, can design risk aggregations that best suit any given set of positions, taking into account how they are traded.

Fourth, GRMA designs and implements high quality, integrated risk reporting for internal use by the fund and for communications to investors. Sam and I bring a depth of cross-fund experience that enables us to spec out and put in place risk reporting that makes clients' key risk exposures substantially more evident, and therefore much more manageable. Most funds have separate processes for internal and external risk reporting. An integrated approach not only improves consistency, but also often saves costs.

Finally, we assist a client fund with effectively managing its portfolio risks.

What is the balance between art and science?

WILSON: Risk management is both art and science. It is grounded in academic and practical methods that I think are fair to be called scientific, such as Harry Markowitz's portfolio theory and quantification of the benefits of diversification across multiple drivers of risk. A second important contribution came from the capital asset pricing model and arbitrage pricing theory, which viewed risk as a function of a smaller number of risk drivers and introduced the idea of risk-adjusted exposure metrics. Options pricing, starting with Black-Scholes, brought out the importance of arbitrage and hedging of risks. Major practical advances in risk calculation and management were made first by trading desks of banks and later by innovators such as J.P. Morgan & Co. and Bankers Trust Co. in firm-wide stress testing and VaR.

However, there is also a vital element of art in effective risk management. Financial markets are complex and dynamic. Risk models can only offer indications, not highly robust predictions, of future portfolio risk. Experienced risk practitioners usually have some insight into the ways that a specific risk model can mislead and/or fail. It is critical that known model weaknesses be factored into risk decision-making, which is one aspect of art. Risk models and risk metrics can and will fail for reasons and in ways that had not been foreseen.

What is the practical meaning of your admonition that "market risks are not linear?"

WON: I have often stated that. Unfortunately, many asset managers and investors do not fully comprehend why these risks do not behave or move in a linear fashion. Most people's brains are wired to think in a linear fashion. And many asset managers and investors have little to no formal training around risk management. So they do not consciously think about the fact that many risks in a portfolio can have either explicit or embedded optionality. Especially in times of crisis or in stressed markets, most investment portfolios' performance and risks do not behave in a linear fashion. This explains why the losses and/or gains in many portfolios have recently moved in non-linear ways and have been far greater than expected or estimated.

How effectively are people getting beyond risk measurement and into true risk management?

WON: We have witnessed and continue to see a number of secular factors converging to cause or force asset managers to start going beyond risk measurement – powerful and ever-growing requirements that are being driven largely by institutional investors and regulators. Asset managers should be asking themselves three questions to determine whether they are institutional quality for risk management: (1) Can your firm clearly state in writing its framework for, and processes and controls around, risk management, and how the risk management process is linked to and intertwined with the investment process? (2) Does your firm have a formal process for measuring, monitoring and reporting its market and credit risks? (3) Does your firm have a clearly defined process for managing risks?

A manager that cannot answer yes to these questions will not be able to pass due-diligence scrutiny by institutional investors and will likely not be able attract and retain assets.

Let's take those one at a time: Risk framework.

It is critical to have a well developed, written description that clearly delineates a fund's risk management processes and controls. This is a must-have for marketing materials. This copy does double duty because much of the information that describes a fund's risk framework is needed to answer due-diligence questions from investors. In our experience, funds that crafted a clearly stated risk management framework do a better job of articulating their risk processes and controls to investors.

Risk Measurement.
To be perceived to have an institutional-quality risk management program, a firm must be able to prove it has a formal program for measuring, monitoring and reporting its market and credit risks to external constituents. An asset manager must be able to demonstrate that it can identify, evaluate and monitor its major risk and performance drivers on both a quantitative and qualitative basis. Furthermore, it needs to document that it reports these risks and trends to portfolio management team members, investors and regulators.

Risk Management.
Prior to 2008, funds that could substantiate that they were able to do some risk analytics and risk measurement typically passed muster with institutional investors. Today, investors are expecting to see evidence of a formal risk management program that includes risk-sizing of positions, risk-based asset allocation and a well-thought-out approach to hedging. One of the key differences since 2008 is that institutional investors are looking to see that funds not only measure and report their market risks, but also demonstrate that they can manage these risks especially in times of volatility and crisis.

How do recent changes in investor due diligence compare with regulatory scrutiny?
WON: Many initiatives are under way that will force asset managers to provide more in the way of risk statistics and performance metrics to their investors, and the form of this information is being standardized to make apples-to-apples comparisons more easily between asset managers. On the regulatory side, the Securities and Exchange Commission and Commodity Futures Trading Commission approved a major initiative last fall that will force almost all registered private fund managers to provide risk-based reporting on a quarterly basis. We believe this information will ultimately be used to assess funds' risk management and the accuracy of their representations of investment risks. The net impact of all of this is that risk transparency will be the norm.

What is the most pressing risk issue that you see facing prospective clients?
WILSON: It is hard to implement institutional-quality risk management at a reasonable price. Even a bare-bones internal risk group requires several professionals. It can cost a lot more to go beyond bare-bones and attract a seasoned CRO with extensive experience across products and market cycles. License fees, system implementation and market data can be costly as well. As a result, my observation is that many large funds and almost all smaller ones lack decent, or in many cases any, fund-wide risk management. Of course, good individual portfolio managers will take account of risks. But, generally, fund-level practices are lagging well behind what most risk experts would deem to be adequate, much less sound or best practices.

From where do you see GRMA's future growth coming?
WILSON: GRMA is structured to reach a wide range of asset managers and institutional investors who previously have not been willing or able to afford institutional-quality risk management. Therefore, our potential market is large, and we have ample opportunity to extend our client base. There are substantial economies of scale in our business, which is a major factor in allowing us to cost-effectively provide our services, which also helps us grow. The product offering is quite developed, but we are constantly striving to extend and enhance our services.

What do you see as the next set of challenges for the industry?
WILSON: The alternative investments industry has a credibility problem with investors. Alternative managers generally performed better in the 2008 crisis than did banks, but that's not saying much. Many managers found they had much more risk in their portfolios, and much less liquidity, than they had thought. Investors felt abused when high-fee absolute return managers delivered large negative returns containing a hefty dose of beta. Investors now do more due diligence, both before and after committing capital to hedge funds, funds of funds or private equity funds. However, the depth of institutional investor due diligence and monitoring lags far behind what is needed with respect to the central, albeit complex, assessment of risk within and across alternative investments. We now need funds to provide improved risk transparency to investors, and institutional investors to greatly improve the risk measurement and management of their portfolios.

Right: GRMA founder Samuel Won, foreground, with COO M. Christian Saxman, left, and senior principal Timothy Wilson.

"Even four years after the crisis, institutions lack the framework, infrastructure, processes, controls and governance for risk management."