DEFINING RISK AT THE MANAGER LEVEL

There are numerous ways for investors to view and manage risk. In this two-part series we take a closer look at assessing and managing risk at the portfolio (Part I) and manager (Part II) levels.

What are some of the most important manager level risks that investors should consider?

Pier Friend: There are many manager-specific risks that seasoned investment professionals consider in determining if or when a manager is appropriate to utilize. A few we view as particularly important include: the use and degree of leverage; the liquidity of the underlying investments versus the liquidity of the investment vehicle; the level of concentration in the investment strategy; the "quality" of the investments; the "crowdedness" of the investment strategy; and for investors with a relative to benchmark focus, the tracking error of the investment.

Can you describe in more detail why a manager's use and degree of leverage is important?

PF: A typical equity or fixed income investment (e.g., a long only mutual fund) will have 100% gross long exposure; however, there are many alternative investments (e.g., private credit, hedge funds, etc.) that may use financial leverage. It is critical that the investor understand the gross long exposure of an investment and whether leverage is an important element in generating returns in the strategy. Typically, more leverage can mean higher return potential, but can also materially increase the investment risk.

Can you provide an example of a manager-specific liquidity mismatch?

PF: As an example, some private real estate investment trusts ('REIT') may have quarterly redemption terms with a cap on the percent of assets (e.g., 5%) that may be redeemed in any quarter; however, the underlying investments in the fund are investments in real estate assets that may, or may not, be liquid. If investor redemptions are significant, the portfolio manager may not be able to sell commercial real estate in that time period and may not be able to sell at the price the assets are marked, resulting in a negative event for all investors – a forced sale of an asset into an illiquid market. Investors in these types of funds may know their own liquidity needs but there is no way for them to predict the liquidity needs of all of the other limited partners in the fund.

How are tracking error and the diversity or concentration of an investment strategy related?

PF: Tracking error measures the benchmark relative risk an investment has to the index it is trying to mimic or beat. The more concentrated an investment portfolio, the more likely it is that the investment will have a high tracking error. High concentration typically equates to high conviction by the portfolio manager. As always, the key is to be aware of the manager's historical portfolio construction parameters and skill operating within them.

How does "quality" equate to the level of risk and expected return?

PF: The term quality is very general and can mean different things to investors, but a few examples may help. In fixed income, a portfolio of investment grade bonds is higher quality than a portfolio of high yield bonds. The high yield fund should generate a higher return over long time periods otherwise it has not been worth the extra risk being taken for the lower quality/more leveraged balance sheets.

In equities, a portfolio of large capitalization companies (e.g., S&P 500) is higher quality than a portfolio of smaller companies (e.g., Russell 2000). Again, over time, the small-cap portfolio should generate higher returns to compensate for the greater risk and volatility being taken with the investment.

The bottom line? There are a myriad of ways to analyze investment risks. Having a framework to navigate all of them is essential and working with an OCIO who has experience in this field can help match the return and risk profile of an institution with its optimal investment portfolio.

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As the Chief Investment Officer of Colony's Institutional Advisory Practices, Pier is responsible for all aspects of the investment process — from manager research to portfolio construction, asset allocation, and client communication. He also supports the needs of our institutional and ultra-high net worth clients.

Pier served as Chief Investment Officer at New Providence Asset Management prior to their merger with The Colony Group in 2021. Previously, Pier spent ten years at Goldman Sachs Asset Management where his responsibilities included Head of the U.S. Core Equity business. He began his career in Japan teaching English as a second language, then returned to NYC where he worked for Nihon Keizai Shimbun before joining Gabriel Capital Group as a research analyst responsible for risk arbitrage and long-short investments for a $1 billion hedge fund. Pier has served on the Advisory Council for the Headmaster of St. Andrew's School.

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