

The *Ambachtsheer* Letter

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RETHINKING RISK MANAGEMENT AND MEASUREMENT

"You can't eat relative performance".

Anon

Shuffling the Deck Chairs

During the 1980s, and especially the 1990s, pension funds (actually, their governors, managers, and consultants) came to a view that risk management should focus on 'implementation' risk rather than 'policy' risk. Thus it was a world in which 'tracking error' relative to some predetermined policy benchmark became the center of attention. Generally speaking, small 'tracking errors' were good, large 'tracking errors' bad. Elaborate risk models, and risk measurement systems and services were built and sold based on this mindset.

Meanwhile, 'policy' risk management and measurement received little more than lip service. Typically, consultants were called in every 3 years or so to confirm that 60-40 was still the right asset mix policy (although this was sometimes stretched to 70-30 during the latter stages of the equity bull market). This conclusion hinged largely on the premise that the historical 5% equity risk premium would continue to prevail in the future. As we (and others) have pointed out ad nauseam, the conclusion was correct, but the premise became increasingly wrong. Indeed, as the 1990s ran their course, any reasonable search for a positive prospective equity risk premium became an exercise in futility (as an aside, we may be back up to 1% today).

Thus most pension funds entered the new decade with a risk management paradigm based on the past, rather than the future. They missed the obvious conclusion that calculations of a prospec-

tive equity risk premium of zero should lead to a major rethinking of asset mix policy. Zero reward for lots of risk makes no sense. Unfortunately, most funds were not equipped to deal with the new risk management context. Instead, they (and their advisors) continued to manage 'tracking error' risk. For their efforts, they were able to keep the fund deck chairs from falling overboard as their entire balance sheets descended under water.

Understanding the 1997-2001 Risk Story

Those that do not learn from history are bound to repeat it. Thus it behooves all of us to understand the 1997-2001 risk story. Fortunately, there is a database that helps tell the story. Since the mid-1990s, the benchmarking firm *Cost Effectiveness Measurement Inc. (CEM)* has been collecting data from universes of U.S. and Canadian pension funds that allows direct assessment of the behavior of 'implementation' and 'policy' reward and risk separately, as well as how the two have interacted with each other during the last 5 years. This *Letter* tells the 1997-2001 reward/risk story, and the lessons to be learned from it.