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Risk Inverse

Peter L. Bernstein

The April 6, 2009 issue of *Pensions & Investments* has an article headed "Survey: Few measure counterparty risk." This innocuous headline contains a remarkable story. If ever anyone were locking the barn door after the horses have been stolen, it is today's portfolio managers. Now that so many poorly managed risks have done bad—over and done with, disappeared from the scene—portfolio managers are hastening to slam the doors shut on their empty stables, the horses long gone. Today's goal appears to be to tighten up on every possible form of risk management. What an odd way to respond! Who wants to duck risk in a passionately risk-averse environment?

Let me give you a flavor of this discussion, with a series of quotes. "The P&I/CMRA survey…found that, on average, respondents spent just $150,000 on risk management in 2008, with the maximum $500,000. They planned to increase the amount by an average of 20% in 2009." "'Clearly, at the board level they're crying out for information on a more frequent basis,' Ms. [Leslie] Rahl said." Or consider Frank Nielson, executive director of core equities for the Americas at MSCI Barra, New York, who reports that pension funds and money managers need risk managers "heavily" involved in plan and portfolio construction. "Then, if something happens, you have the risk committee sit together and…really use the data coming from all corners of the…firm….The risk management function needs to step up and become a more senior component of plan and portfolio construction." Or this anonymous board member: "We now see that along with a risk system, we need a better way to look out at the big picture and find a better way to identify and manage risk." To cap it all off, the reporter tells us the following: "Several respondents said the crisis completely eliminated any belief that risk free investments exist….The big unanswered question is: *Will the credit crisis and ensuing drop in capital markets and global recession finally kick pension boards and executives into action?*" [italics added] An earlier and associated article quotes Karyn Williams, managing director of Wilshire Associates, who recommends that, "You have to think of the unknown unknown and what you would do if an unexpected event were to occur."

Dear Readers, where have all these folks been? They act as though unexpected events were a novelty of the past two years, something never before encountered. After the fact, after the big risks have paid off with horrible surprises and big losses, after the unknown unknowns have become known, after the big picture overwhelmed all the little pictures, these investors and their advisors are finally beginning to ask the right questions—questions they should have been asking before the fact rather than after it.

This last observation is precisely the point I want to make here. As the *P&I* article reveals, risk aversion among investors is as intense today as the appetite for risk was insatiable before the crash and the crisis. Why tighten up on risk management under these conditions? On the contrary, if taking high risks when everyone else was doing the same thing proved to be an extremely dangerous strategy, why rush into elaborate forms of risk control today when most investors are shedding risk and cannot even abide the use of such a four-letter word? It makes no sense to me.