The Journal of Portfolio Management

INVITED EDITORIAL COMMENT

Risk is a Choice Rather Than a Fate

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The passing of Peter Bernstein is an occasion to celebrate his enduring legacy. A prolific and influential writer, Peter's thinking was always informed by his deep knowledge of practice. He had witnessed firsthand the evolution of the investment business from its early beginnings, and he understood the difference between good investing on the one hand, and institutional practices that evolved because of poorly aligned incentives on the other. Having been in the wealth management business in one way or another virtually all of his professional life, his perspective was that of the client's portfolio in its entirety.

Issues of risk and risk management were front and center in Peter's mind. In *Against the Gods: The Remarkable Story of Risk* (John Wiley and Sons, 1996), he wrote:

> The word "risk" derives from the early Italian risicare, which means "to dare." In this sense, risk is a choice rather than a fate [emphasis added]. The actions we dare to take, which depend on how free we are to make choices, are what the story of risk is all about.

In 2003, Peter caused a stir when he critiqued the use of stable asset allocations ("policy portfolios") in investing, calling such strategies "obsolete". If Peter understood anything, it was that the investment opportunity set was not static. Adherence, therefore, to a stable allocation such as 60/40 stocks/bonds would be suboptimal for many investors. If the economic environment changed over time, so too

Exhibit: Changing Forward Looking Equity Market Risk in 2008

	S&P 500 Return	Beginning Implied Volatility (Monthly S.D.)	Return Divided by Implied Volatility	Return Divided by Normal Volatility
Jan	-6.0%	6.7%	-0.9	-1.4
Feb	-3.2%	7.4%	-0.4	-0.8
Mar	-0.4%	7.5%	-0.1	-0.1
Apr	4.9%	7.5%	0.6	1.2
May	1.3%	6.1%	0.2	0.3
Jun	-8.4%	5.6%	-1.5	-2.0
Jul	-0.8%	7.0%	-0.1	-0.2
Aug	1.4%	6.6%	0.2	0.3
Sep	-8.9%	6.3%	-1.4	-2.1
Oct	-16.8%	8.9%	-1.9	-4.0
Nov	-7.2%	15.8%	-0.5	-1.7
Dec	1.1%	15.4%	0.1	0.3

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would the risk and expected return of a fixed policy allocation. Peter's concerns were not only that investors were failing to adapt their allocations to changed circumstances, but also that their definition of risk had become the risk of deviations from the policy portfolio, instead of overall portfolio risk itself. In 2008, Peter's point was made in spades: investors who adhered to a stable allocation found themselves involuntarily taking risk far beyond what they would have considered prudent for their institutions.

The fact is that it should not be difficult to factor in changing risk circumstances when managing the asset allocation of a portfolio. It is not a blind guess as to whether one is in a high or low risk environment. Market volatility is an indicator of risk, as is the volatility priced into put and call options ("implied volatility"). Implied volatility correlates highly with the market's assessment of future risk, and investors can use such volatility assessments to better adapt their asset allocations to changing risk environments.

Implied equity market volatility was high going into 2008. Measured by this statistic alone, the risk environment had worsened and the range of likely outcomes in 2008 had widened. In particular, the chances of a large market decline had increased. Specifically, at the end of December 2007, implied future one-month volatility of the S&P 500 was 6.7% (Exhibit), much higher than the post-WWII average volatility of monthly returns of 4.2%. By November 2008, implied future volatility was nearly four times normal market volatility. The last column of the Exhibit shows that based on normal volatility, June and September were two standard deviation down months, while October was a four standard deviation down month. Based on the market's then forecasts of volatility, however, the monthly outcomes were much less extreme. October, for example, was a 1.9 standard deviation event, an unlikely but not especially rare event. The October decline, in other words, was less shocking when viewed in terms of the risk environment in evidence at the beginning of the month. The market had correctly anticipated a wider range of outcomes.

The point is that risk changes over time, and that indicators such as implied volatility provide information that correlates with future risk. In saying that static policy portfolios are obsolete, Peter Bernstein was not asking for clairvoyance, just for investors to factor the present investment environment into their asset allocation decisions. He was urging fiduciaries to understand that risk is a choice rather than a fate.

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