Three Misconceptions About Risk Management

Minimizing risk is the objective of risk management.

Managing risk is not about minimizing risk. Rather the objective of risk management is to take the right amount of risk, of the right kind, at the right times. Just as there is a cost to taking too much risk, there is a cost to taking too little. The goal is to take the right amount of risk, no more and no less, that's required in order to generate the right level of expected returns for each strategy.

Market risk is the primary focus for a risk management team.

Risk comes in many forms. Risk managers who focus only on market risk overlook other important forms of risk including counterparty risk, model risk, operational risk, and technology risk. For example, some of the biggest market drawdowns have been due to misunderstanding the role of counterparties. Therefore, it's very important to have a broad perspective on all the different categories of risk facing a strategy. This includes how much and what types of risks are appropriate, what are the potential impacts from these risks including during stressed environments and, importantly, what controls are in place to effectively manage these risks to appropriate levels.

Risk can be measured.

Risks generally can be estimated but not measured. For example, if an investor has a global fund and is worried about the impact of a sell-off in oil, the projected impact on his portfolio is entirely dependent on the relationship between the price of oil and the assets that are held. That risk can only be estimated -- sometimes the relationship between oil and any given asset may be strong and sometimes it won't be.

It's imperative that the investor see the potential impact from as many different angles as possible. If they happen to estimate the risk based on a period where the correlation between oil and their holdings are low, they may assume their risk to an oil move is benign. However, had they estimated this same risk using different assumptions, the expected outcome to such a move might have been meaningfully different. Therefore, when mapping out the risk profile of a strategy, it should be based on a series of estimates to better understand the range of potential outcomes.

It is also important to remember that while historical events may provide a reasonable guide post to potential risks, monitoring exposures to these events could be a starting point in risk management but it should not be the end. The goal should be to best position a portfolio to weather not just the last storm but the ones we haven't seen before.