[Portfolios]
I've been thinking about…

… practical risk management in the new reality

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Greg Cooper | CEO | Schroders

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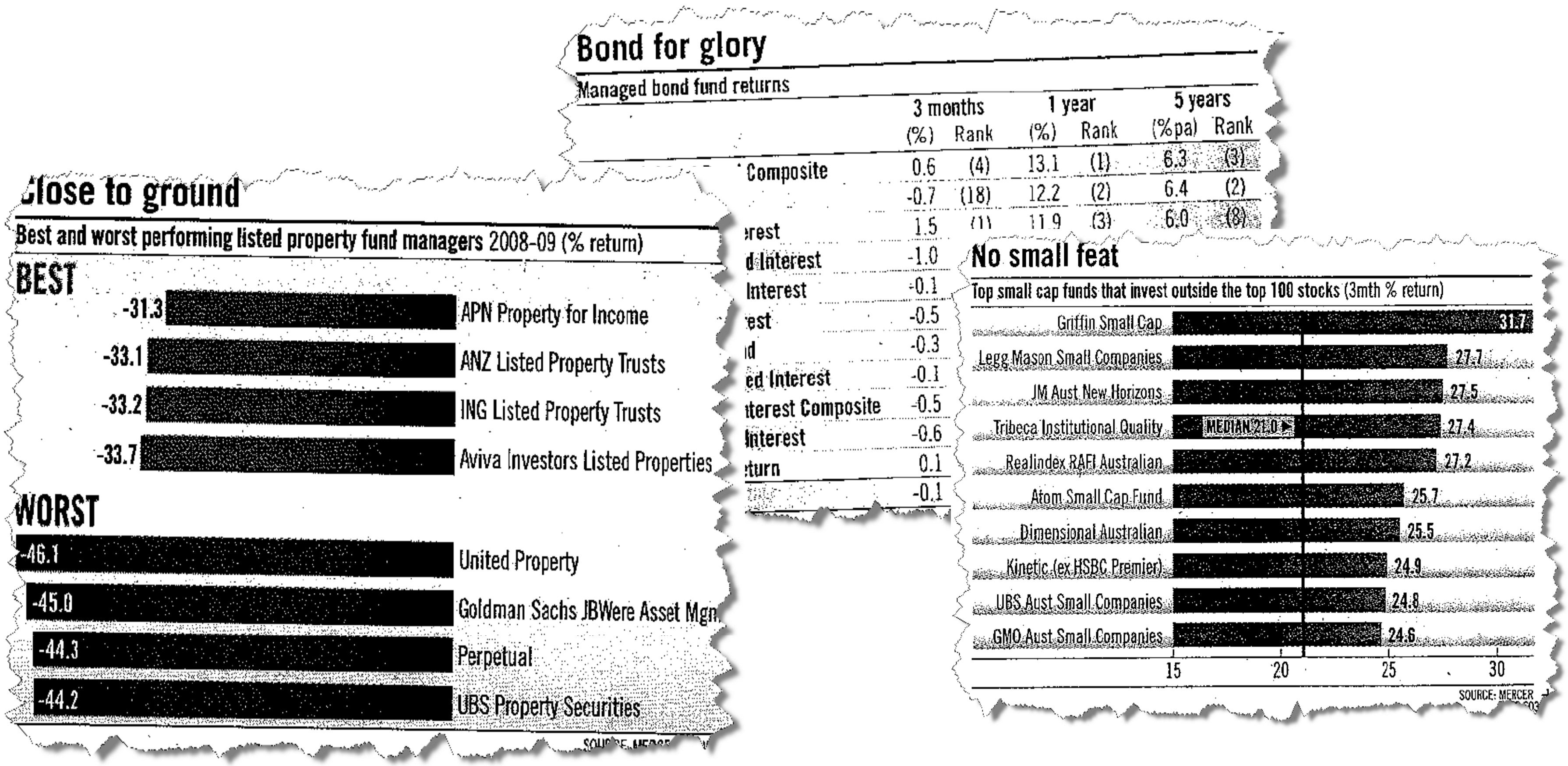
PortfolioConstruction Conference 2009
Investing in the new reality

Greg Cooper
Chief Executive Officer
Schroder Investment Management Australia Limited

August 2009

Schroders

The industry focuses on return….not risk



What is risk and how much is appropriate?
Volatility commonly used but downside risk matters most

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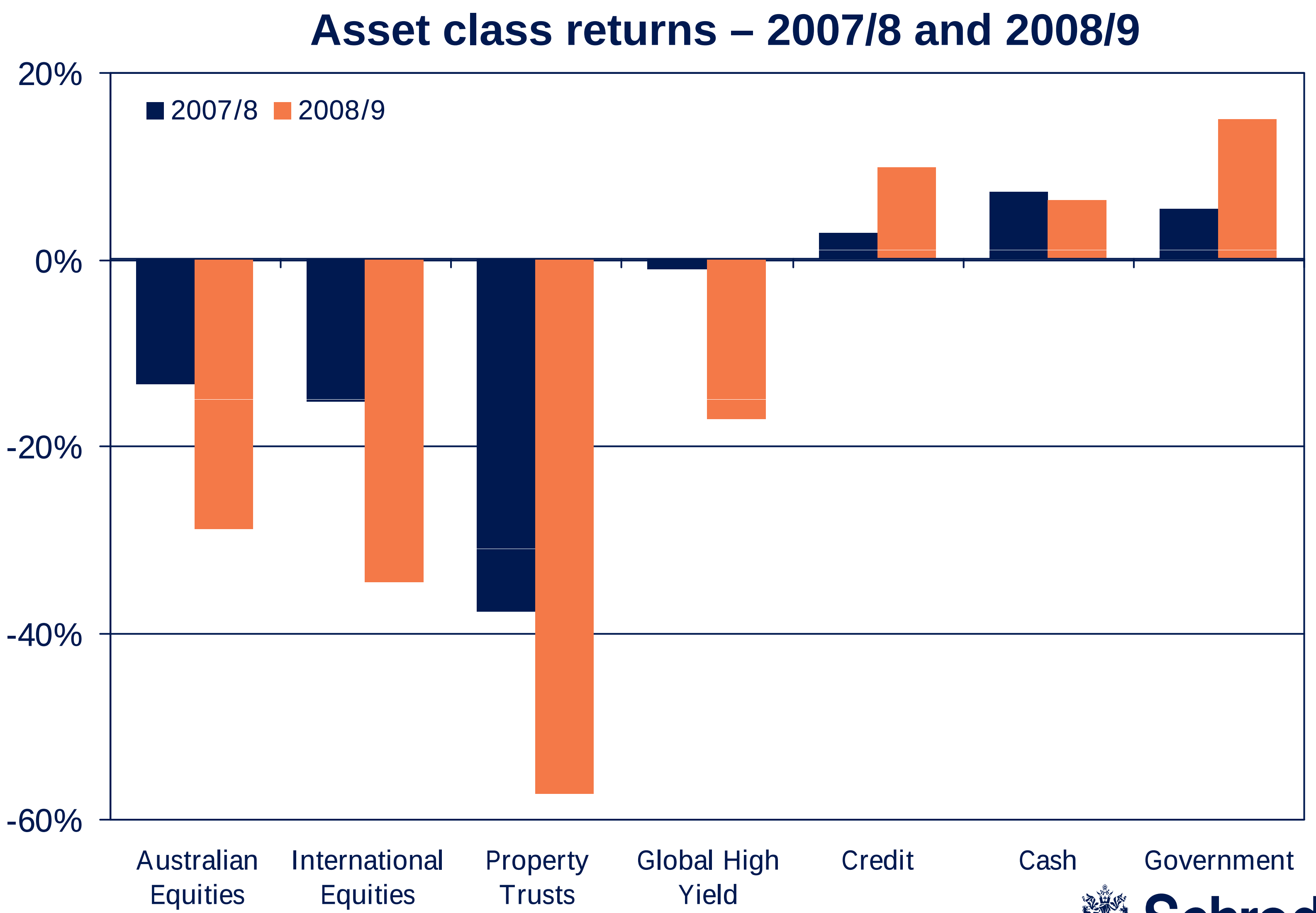
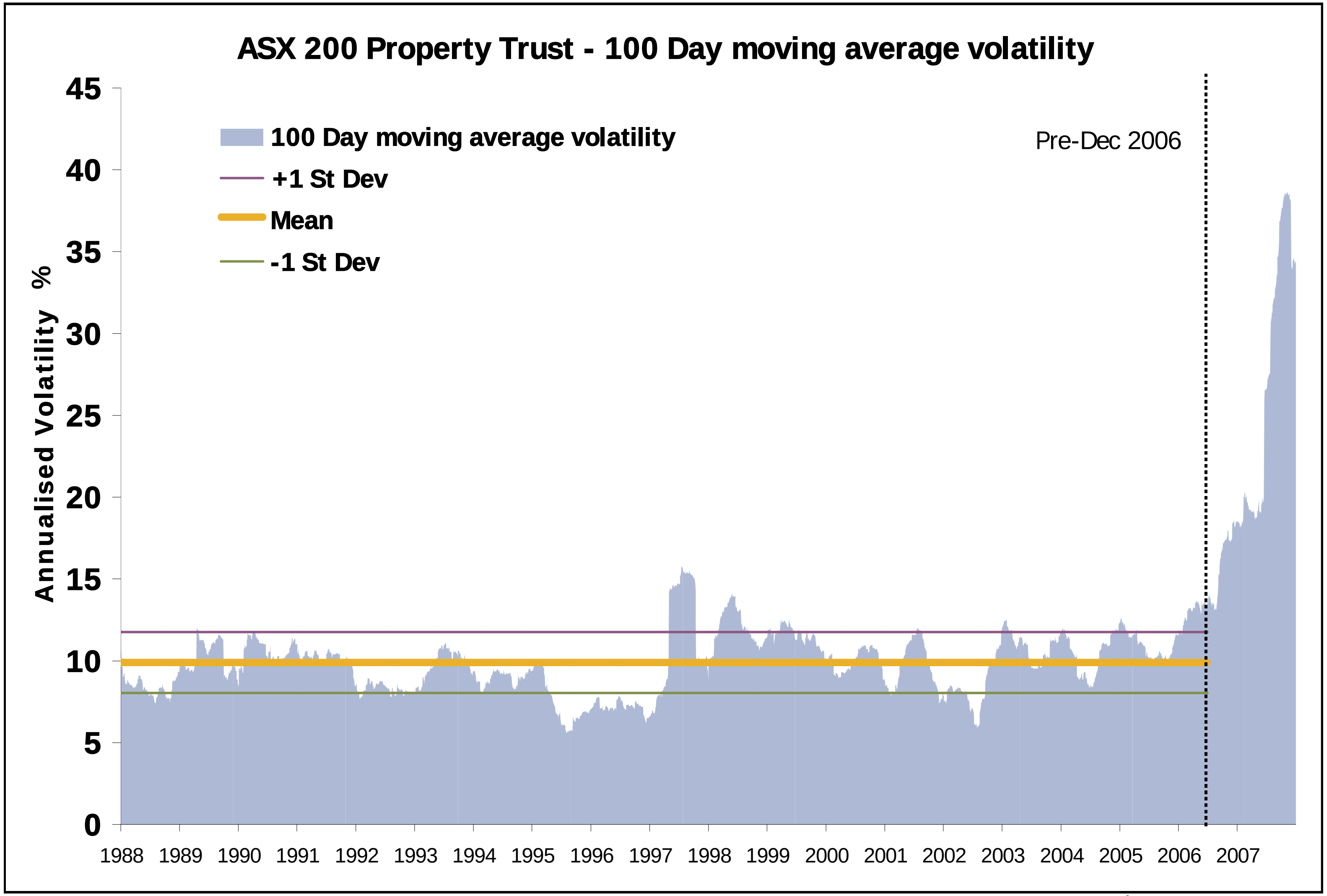
The last two years should have taught us about risk



 Source: Schroders, Datastream

We focus on the wrong things

Stability can hide real risk



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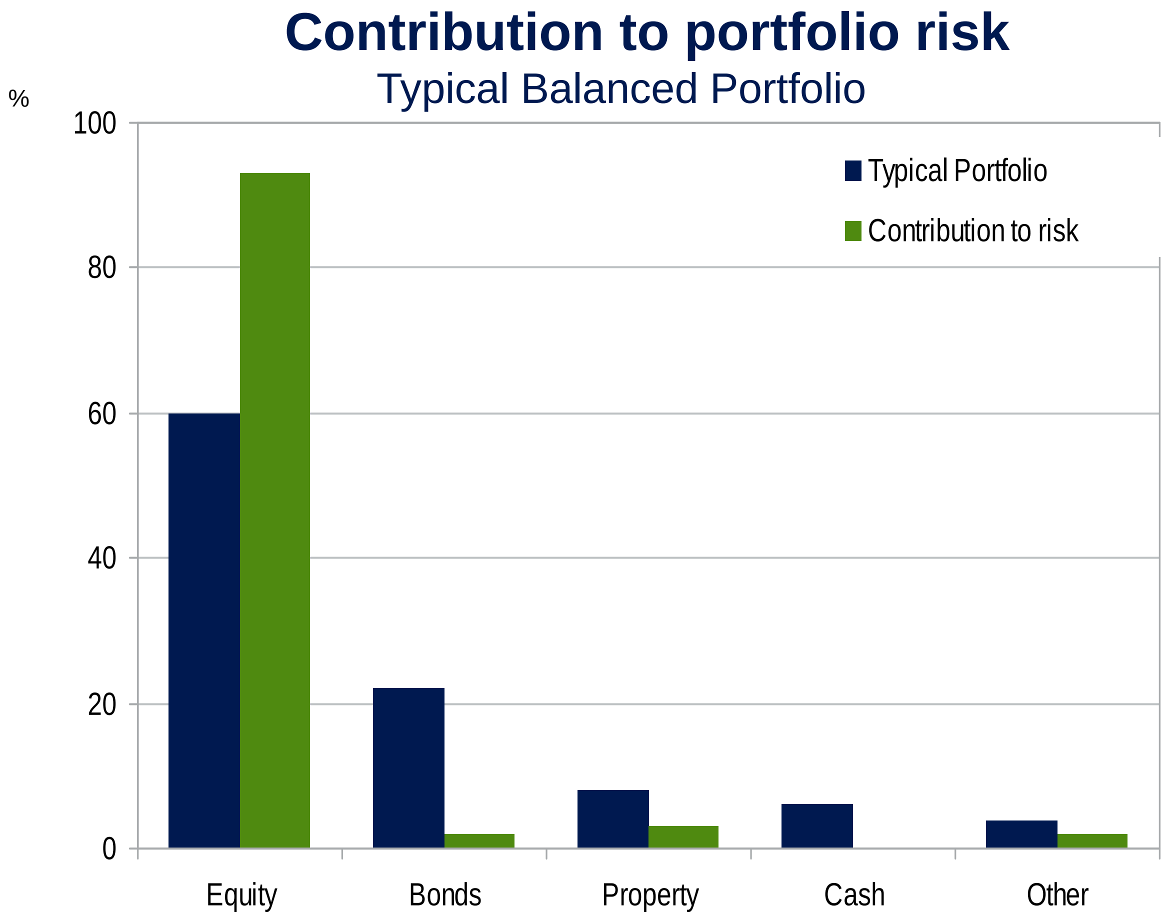
 Source: Goldman Sachs JB Were, Schroders

Equity risk dominates most portfolios

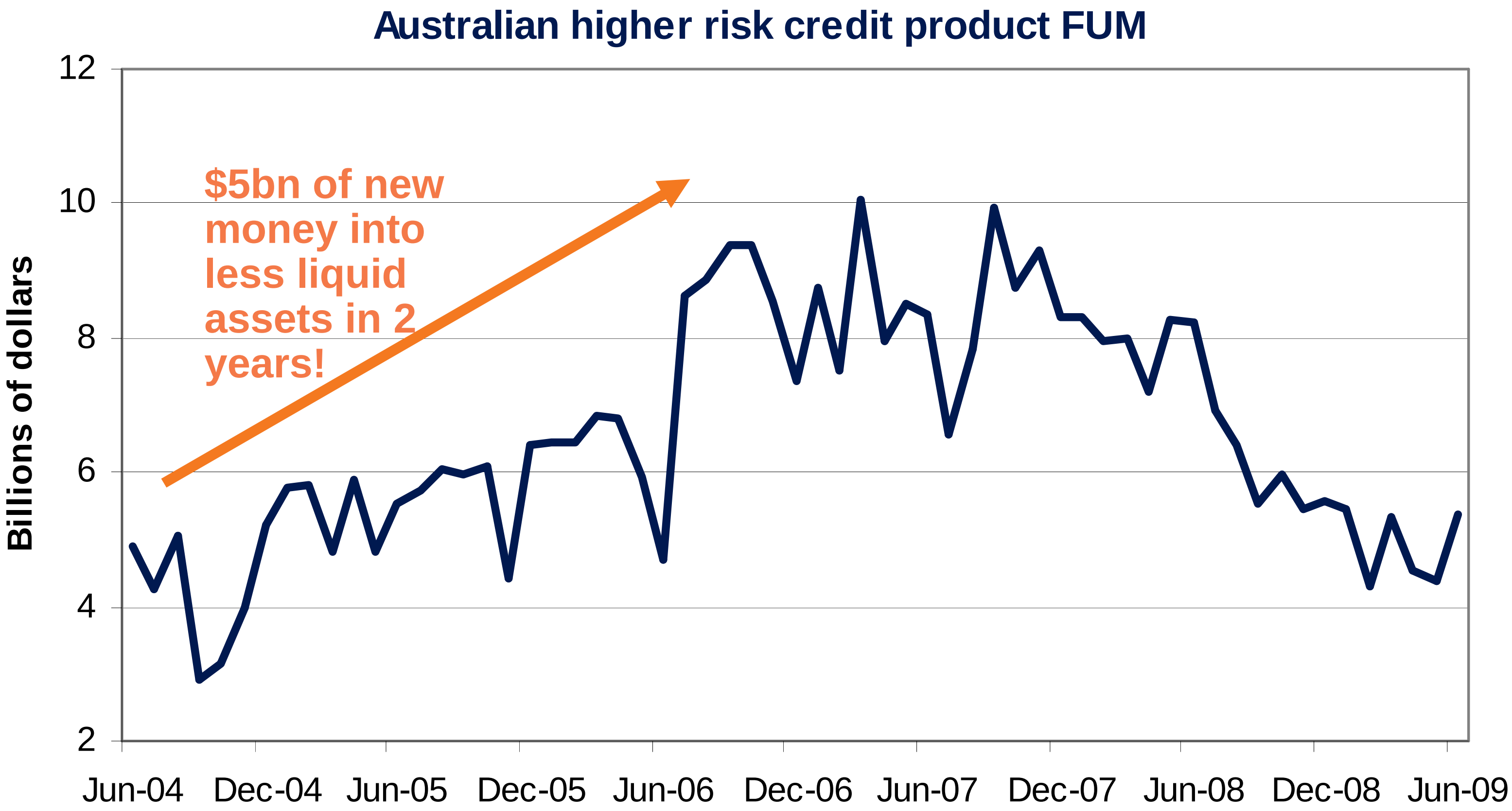
A key lesson of the last 2 years - don't duplicate your risk exposures

- "Beta" risks make up 99% of the typical portfolio's total risk
- Be very careful where you take your beta!
- The use of asset class "buckets" meant many investors increased risk when they didn't want it – eg credit



 Source: Schroders, SMART

Credit flows surge



Source: Schroders, Morningstar, Aggressive Mortgages + High Yield + Credit pooled fund FUM

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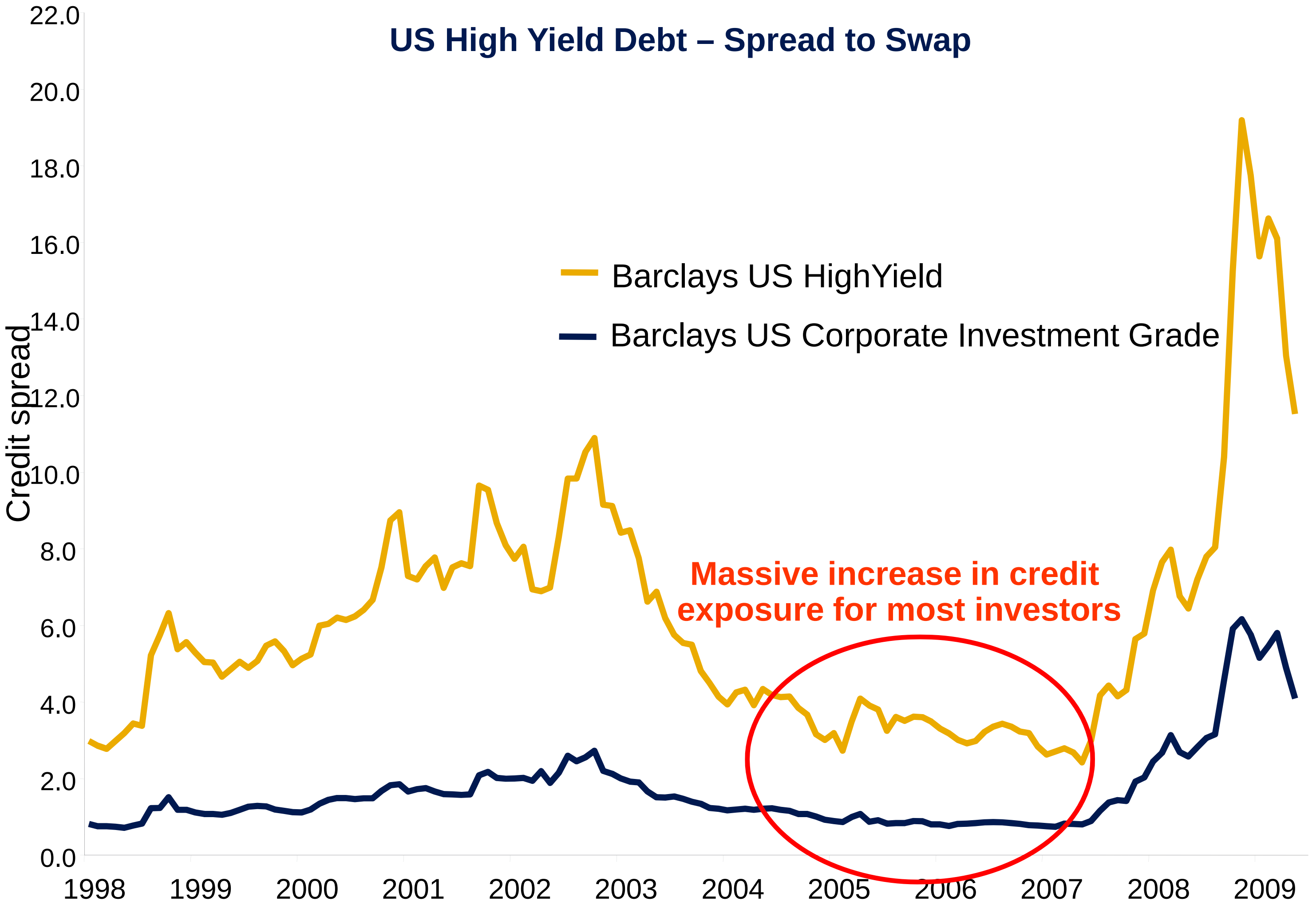
When the premium for risk was lowest



 Source: Schroders, Datastream

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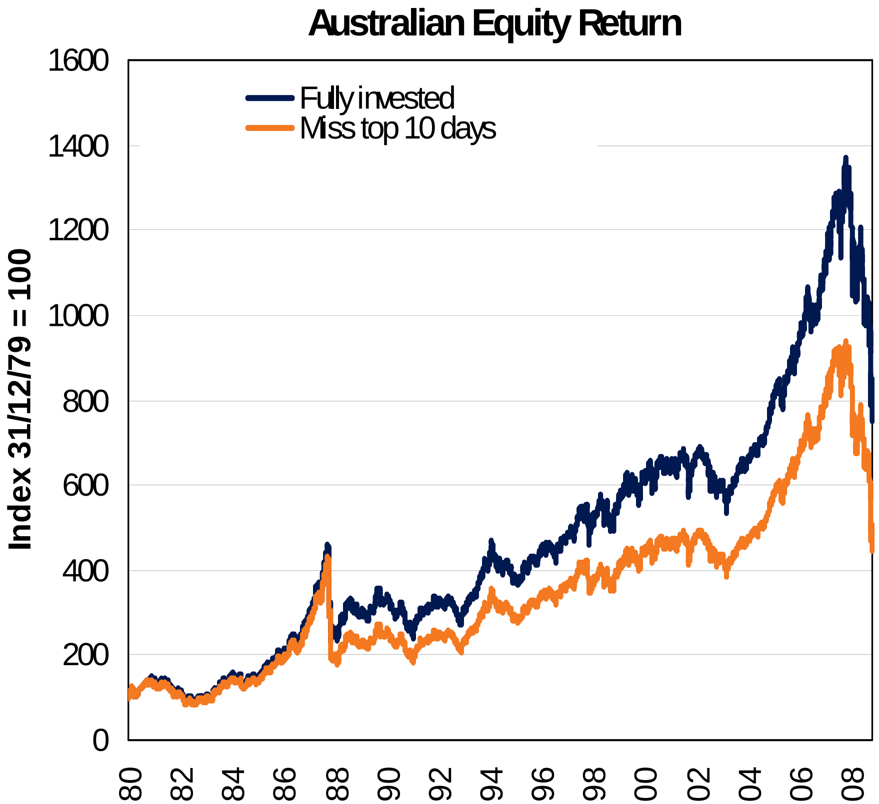
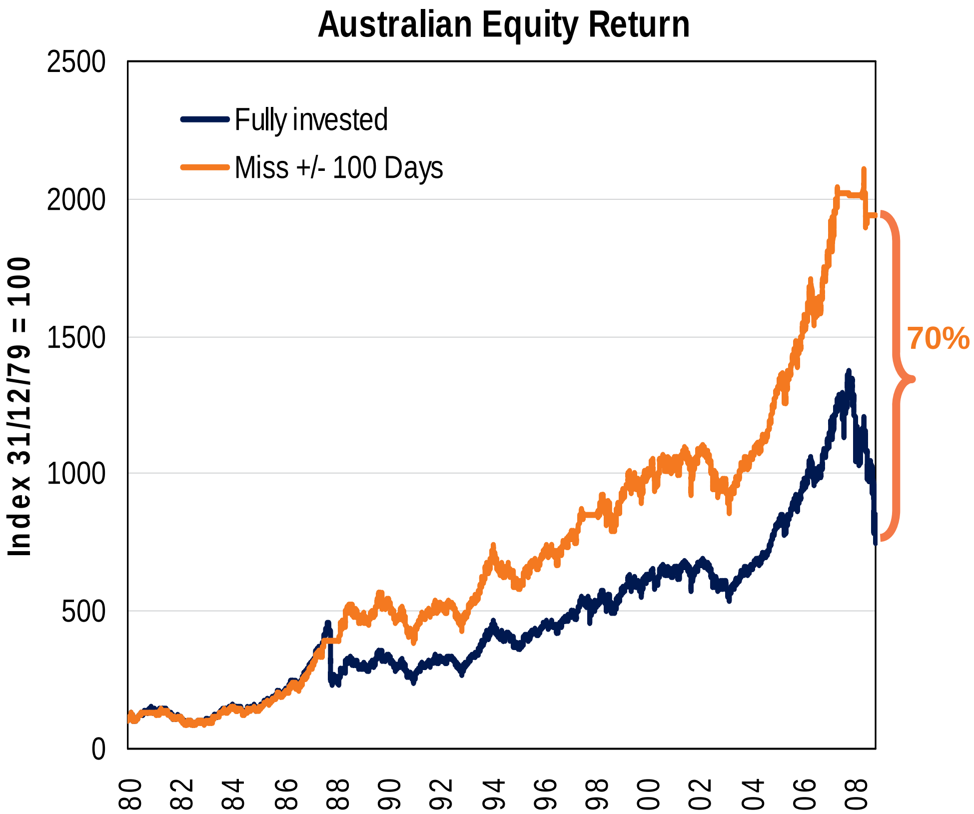
Time in the market vs timing the market?





 Source: Global Financial Data, All Ords, Schroders, Nominal terms, no dividends

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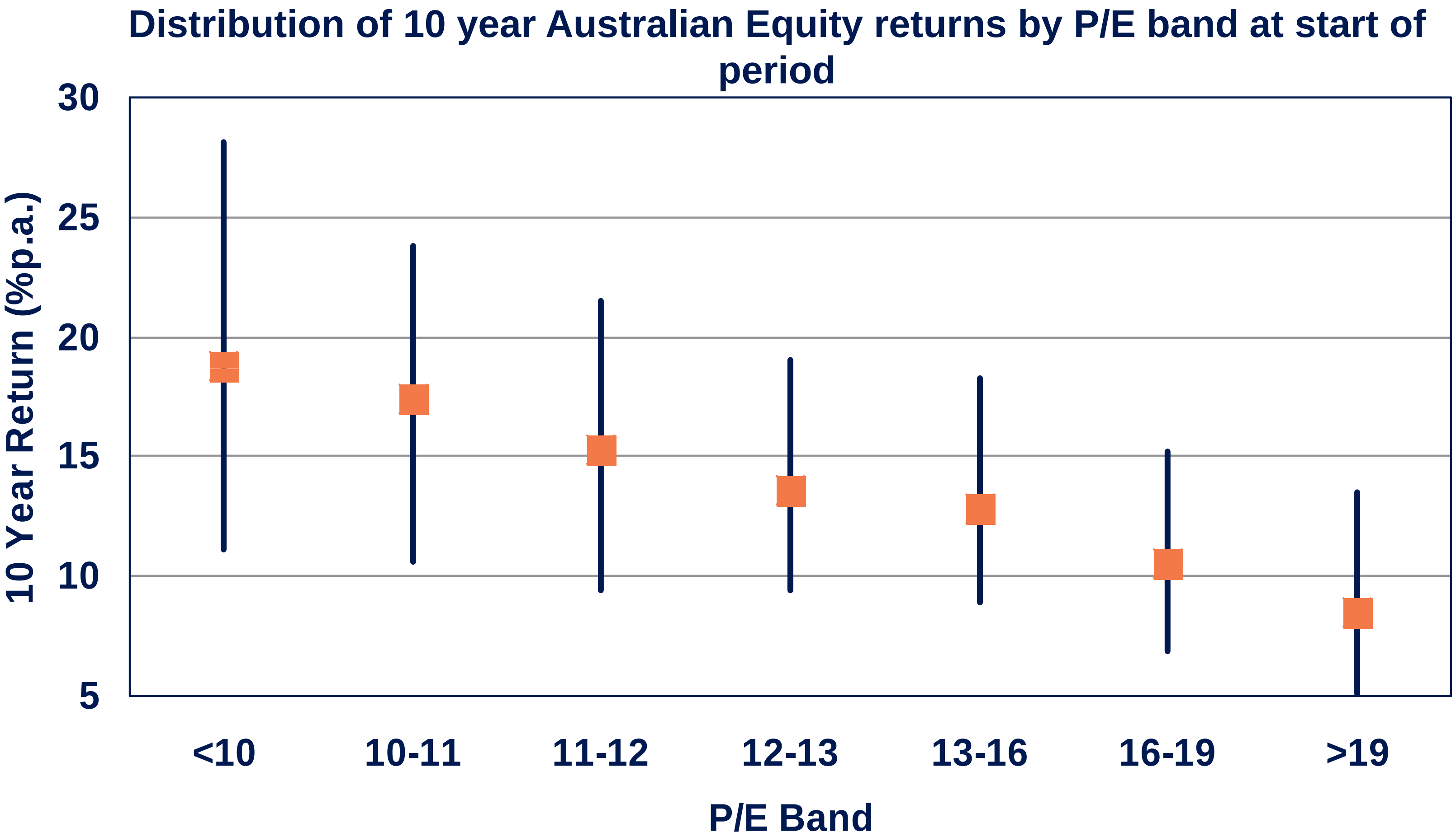
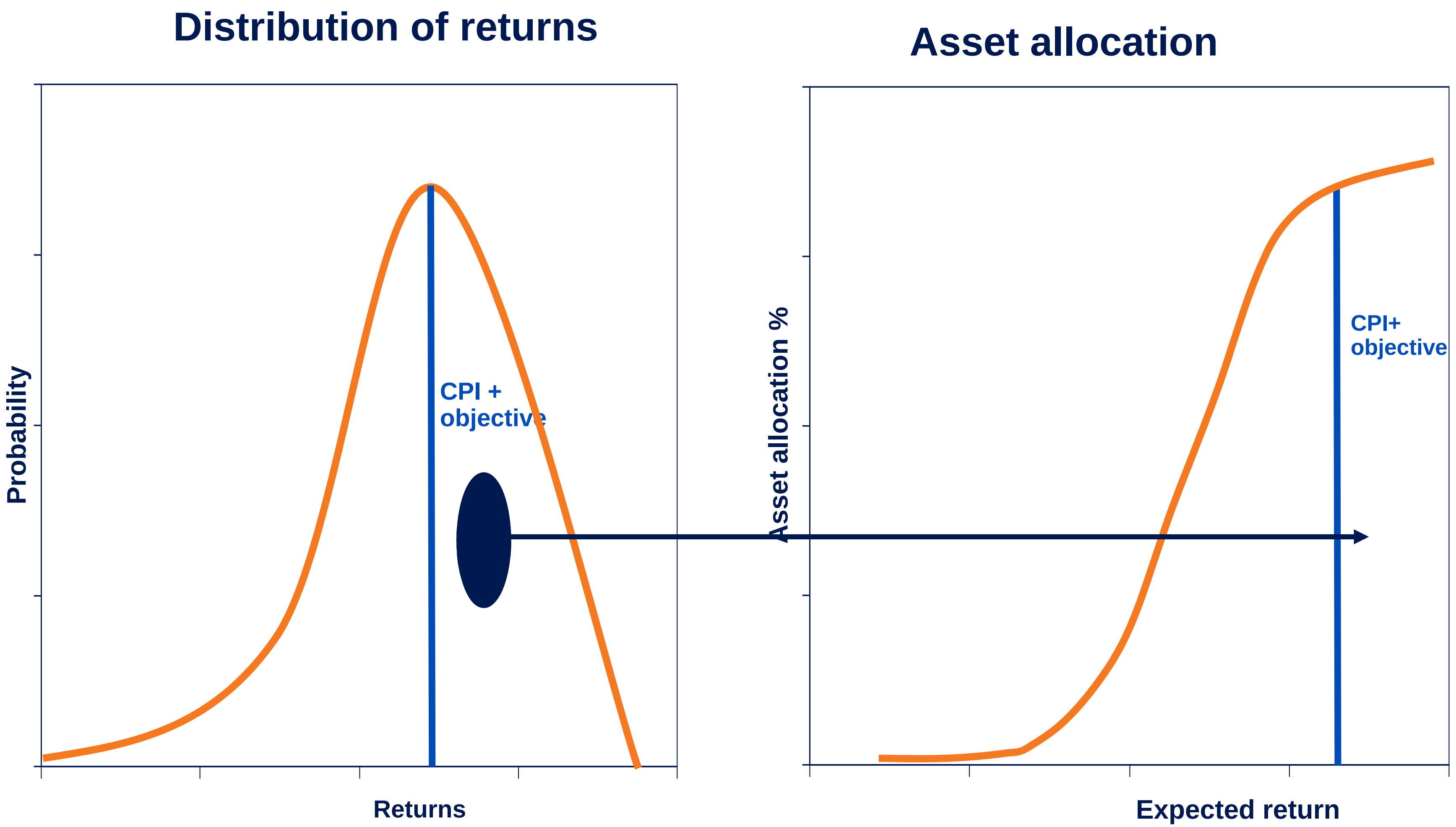
Price of equity cash-flows impacts return significantly



 Source: Schroders, Datastream, MSCI Australia from 1/1/1970 – 31/7/09

Manage asset exposure like stock exposure

What price are we paying for those cashflows?



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Source: Schroders

Conclusion

– **Think and understand exposures – especially exposure relative to objectives**

– **Continually re-evaluate spectrum of risk-return tradeoffs**

– **Enhance the speed with which capital can respond to opportunities**

– **Path dependency matters to your clients**

– **Manage what really matters - asset allocation**

– **The core of your portfolio should be <u>objective based</u>**

Thank you!

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James Purvis | Director | Active Portfolios

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Conventional wisdom.

- Modern portfolio theory (1952) based on stable correlations of returns in asset classes.
- Diversification across asset classes works.
- Diversification within asset classes works.
- Risk is measured by standard deviation of returns and returns are normally distributed.
- Why does it not work as we expect?

Risk redefined & experienced

- Risk is the likelihood of not getting the returns you expected.

- Experienced in the form of:
    - Capital losses –temporary or permanent, in nominal or real terms.
    - Income losses- in nominal or real terms.

Proximate causes of risk

- Income defaults – credit risk, fraud.
- Property vacancies- tenant failure, market demand downturn
- Profit shortfalls- revenue losses, operating leverage, financial leverage.
- Market re-pricing of assets- responses to income or profit changes.
- Convergence of returns in markets.
- i.e. Symptoms not causes.

Portfolio theory does not help

- Portfolio theory looks elegant but it depends on well understood correlations which are stable over time.
- Lack of enough data for statistically significant conclusions undermines its reliability.
- Correlations are not stable over time (ask yourself why?)
- In any case observing a correlation is not the same as establishing cause and effect.
- Need to identify the mechanism of causes. (e.g. smoking & lung cancer analogy).
- Focus on underlying causes of risk and manage them.

Ultimate causes of risk

- Insufficient skill and experience of managers of businesses, funds, financial institutions, regulators and legislatures.
- Underestimating the complexity of financial markets and instruments.
- Poorly designed processes for managing businesses and funds including the role of perverse incentives.

Practical steps to limit risk-part 1
Realistic diversification at the asset allocation level.

- Avoid having too many asset classes as they provide illusory diversification
  - Driven by product manufacturers
- Avoid the big picture, flavour of the month traps.
- Simply think in terms of risky and defensive assets.
  - Defensive assets : cash & short term government fixed interest (think about the reference currency)
  - Risky assets : everything else

Practical steps to limit risk-part 2
Asset selection- avoid the pitfalls:

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- Paying too much when buying assets - following the crowd. (Have a fair valuation basis)
- Agency risk in fund managers. (Take care with remuneration incentives)
- Investing in assets where the returns and risks are not fully understood. (Take the time and money to understand or else avoid them)
- Ignoring the risks inherent in illiquidity (Demand enough of a return premium on illiquid investments).
- Placing too much credence in the people even where they have no demonstrable experience in successfully managing businesses or funds – including former politicians, sportspeople, “blue chip” directors. (Take the time and money to obtain and examine the evidence or else avoid investment).
- Investing with known incompetents or scoundrels. (Read some history, make enquiries)

Unconventional wisdom

- Little has changed or is likely to change as a result of the GFC.
- Return distributions are not normal (fat tails and black swans abound).
- Perverse incentives and the agency problem will persist to the detriment of investors.
- Most listed companies, fund managers, superannuation funds, advisers and investors will achieve mediocre or worse results in the years ahead -sometimes deliberately.
- Try not to be among them.

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