INVESTING RISKS

THE RISKS INVESTORS TAKE

A multi-year study by Northern Trust Asset Management of global asset owners revealed how some of their investment risks have evolved over three years

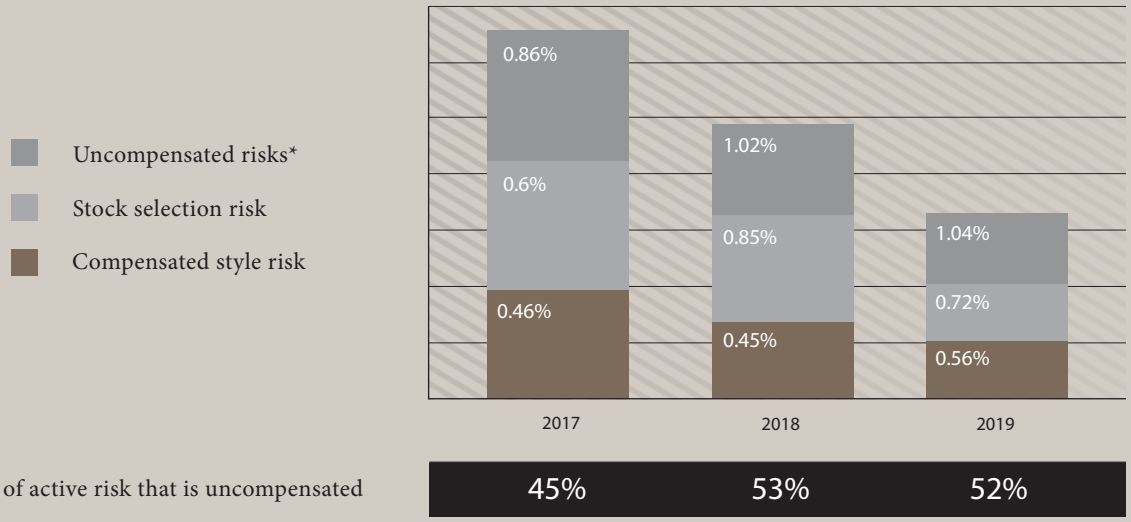
BY RICHARD MORROW

Asset owners across the world are finding themselves having to reconsider their approaches to investing amid a lower rate environment. But, judging by a report focused on investor risk from Northern Trust Asset Management that was published in November, one thing these institutional investors should first focus on is making sure their own portfolios do not accidentally minimise the risk they want to take.
The report considers performance and asset allocations from 64 institutional investors across the world over four years. These investors had over $200 billion in assets and had over 1,000 investment strategies. All-told, the survey reveals that many of these investors were effectively reducing their active equity risk by about half, due to having different investment managers cancelling each other out with their strategies.

All the below charts have been sourced from 'The Risk Report' by Northern Trust Asset Management, released in November.

HOW INVESTORS' ACTIVE EQUITY RISK HAS CHANGED

Asset owners' portfolios have seen their uncompensated risks grow across 2017 to 2019, which may have reduced their potential to make excess returns. While active risk is needed to make outsized returns, some risks are…riskier than others. Those that have been seen to offer excess returns over long periods are compensated risks; those that do not are uncompensated risks.



* includes currency, style, country, sector

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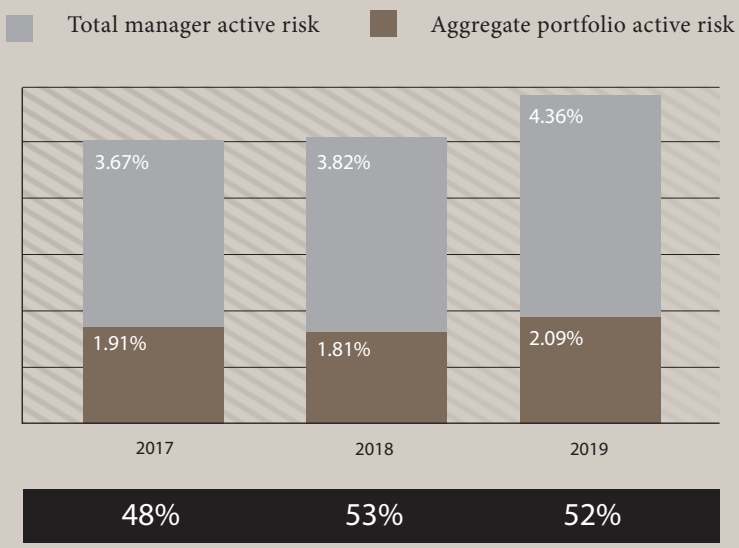
THE CANCELLATION EFFECT

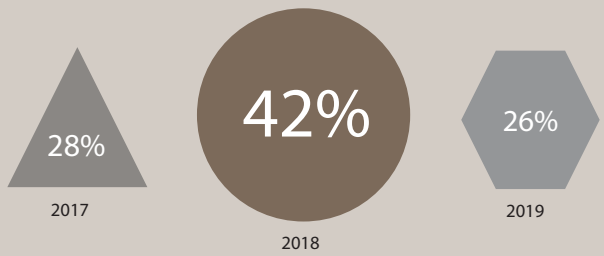
Institutional investors look to hold diversified portfolios, utilising multiple funds and strategies to spread their risk. But unless calibrated carefully, underlying managers may partly each other's active risk positions out, reducing overall returns.

For example, one external manager for an asset owner may hold a 3% overweight in one company while another manager with a similar mandate holds a 3% underweight, effectively cancelling out the position – or if one manager takes a high growth strategy, while another takes a high value strategy.
All-told, over half the active risk positions of asset owners have ended up being cancelled out during 2017 to 2019.



THE UNCERTAINTIES OF OUTPERFORMANCE

ACTIVE STOCK MANAGER PERFORMANCE



COSTLY RISK-TAKING

Overall, roughly 50% of aggregate portfolio aggregate risk was lost because of underlying investment manager active risk positions cancelling each other out. That meant that asset owners were paying twice as much per basis point of active risk as might have been originally through.

THE COSTS OF TOO MUCH DIVERSIFICATION

A major impact of the cancellation effect is that asset owners end up combining a set of diversified managers that, when combined effectively reduce their active risk and ends up giving them a portfolio that mimics a benchmark-like return, but for far higher fees. The more managers that are hired, the more rapidly average active stock selection risk can deteriorate. Whereas asset owners that hired five managers or less saw a decent level of stock selection risk, this sharply deteriorated as they added up to nine and worsened even more when it reached 10 or more.