Commentary

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Risk Management: The Intelligent Pursuit of Risk

- Investment management requires intentionally pursuing specific risks; a prudent balance can set the stage for attractive returns in rising markets and limited losses during downturns.
- Intentionally seeking risky investments is counterintuitive for most investors, as the pain of losing money tends to be more acutely felt than the joy of gaining money.
- Our risk management process incorporates multiple layers of quantitative and qualitative assessment, keeping the goals of our investors in mind.

In most facets of life, we tend to associate risk with downsides: the risk of injury from slipping on ice; the risk of perishing in a plane crash; the risk of property damage from a flood. Risk, simply put, is something to be avoided.

As investors, however, risk is something to be actively, yet intelligently, pursued. Striking the right balance of specific risk exposures — with the goal of increasing returns, both at the asset class and overall portfolio levels — can not only mean increased returns in favorable environments, but also limited losses during unfavorable ones.

For example, stocks tend to experience material losses when the equity market drops; we call this *equity market risk*. Investors are still willing to own stocks despite such volatility because stocks have historically delivered elevated annualized returns.

Bond investors may be familiar with *credit risk*, which is essentially a measure of how likely a borrowing company or government will be to make their interest and principal payments. High yield bonds offer more income than investment grade bonds to compensate for greater credit risk exposure.

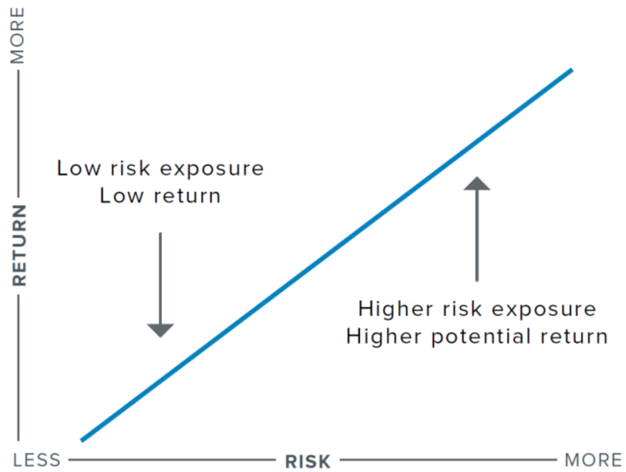
Interest rates are also important in fixed income analysis; a bond's price will typically decline when prevailing market rates increase, since the fixed interest rate paid by the bond becomes comparably less attractive. All else equal, a bond that matures in a year will be less sensitive to that change, and therefore exhibit less *interest rate risk*, than a bond that matures in ten years. Longer-term bonds typically offer higher fixed rates so that investors will purchase them even with the knowledge of their sensitivity to interest rates.

Risk Management ≠ Risk Aversion

While seeking risk is an important aspect of achieving investment goals, it can be a difficult practice for many investors. Studies show that investors feel the pain of an investment loss much more acutely than the joy of a gain — and therefore tend to be disproportionally risk averse in relation to their expected outcomes. (See our Behavioral Finance series.)

In other words, the act of pursuing and maintaining risk exposure runs against investors' instinct to prevent capital loss, however temporary. As such, risk management not only works to minimize risk exposures that fail to adequately compensate investors, but also encourages risk exposures that we believe are more likely to be rewarded.

Exhibit 1: The tradeoff between risk and return



Source: SEI

As goals-based investing adherents, we believe the greatest risk facing investors lies in the failure to achieve their objectives and cover future liabilities. Therefore, we seek risk exposures that we believe will help increase returns so that our investors can achieve their goals.

Our Culture and Principles

Even the most skilled investors can use help maintaining objectivity when balancing risk exposures. We therefore believe it's important to separate portfolio management from risk oversight, as we do in SEI's Investment Management Unit.

Our risk management team operates autonomously, decomposing every security and portfolio down to a set of risks (or, in more technical terms, systematic economic and market factors that explain the variability of a security's returns). This risk model helps us answer several questions:

- Are the risk factors consistent with the fund or strategy's mandate?
- Is their presence intentional?
- Do they represent excessive exposures?

This is not to say that our portfolio managers and analysts are not also responsible for monitoring and managing risk budgets. While our risk management team conducts analysis independently, it is also tasked with educating our investment teams about risk sources and metrics. We are each risk managers in this sense. This shared understanding and responsibility forms the basis of our culture.

Risk Management: Measurement to Goals

To learn more about our approach to risk management, stay tuned for a series of forthcoming papers. Specifically, we plan to address the following, in terms of their contributions to risk management:

- Setting a risk-management framework
- Measuring and monitoring risk
- Investment manager research and due diligence
- Asset allocation and constructing portfolios
- Balancing risk for goals-based investing

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

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