

Driving OCIO Governance Through Risk

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Executive Summary

Risk is the currency which pays investors a return. The type, and amount, of risk exposure that an investor chooses to take on is one of the greatest determinants of portfolio performance and outcome. This rule of thumb is also inherently true for OCIO providers, though to a slightly different degree. In OCIO portfolio management, once an investment policy index is determined, it is active risk (tracking error) which plays a large role in determining portfolio outcomes and success relative to that policy. Active risk is generated any time that a portfolio exposure is different from the policy benchmark and therefore leads the portfolio to perform differently from the policy benchmark. Active risk includes: traditional active management, long-term portfolio structure decisions such as beta bets (specific positions in equity, credit, rates, or other market betas) and style bets (value or growth, small-cap, etc.) that are different from the policy benchmark, tactical tilts meant to take advantage of short-term market opportunities, and portfolio rebalancing approaches. But active risk is also often generated on accident, through benchmark mismatches between a policy index benchmark and the benchmark an active manager is focused on, for example. As an OCIO provider, we believe much of our role is to thoughtfully take on active risk in areas that offer the most attractive risk-adjusted payoffs for our clients, with a preference for consistency of outcomes.

What are the sources of active risk?

Active risk is potentially generated from four sources in any portfolio. Below we briefly outline each of those sources and preview a quantitative tool that Verus uses with clients to understand how each source is contributing to total portfolio active risk.

Active Management: Traditional active management risk is perhaps the first risk that comes to mind on the topic of active risk. Active management risk is generated from active strategies and the decisions taken in attempts to outperform the strategy benchmark, such as through stock selection.

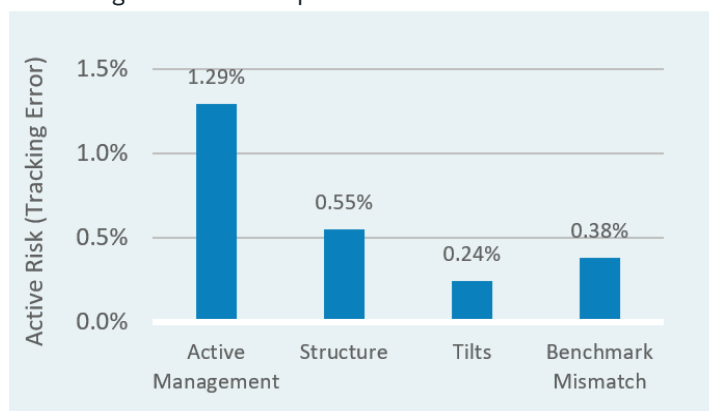
Structure: Longer-term “structure” decisions - specific and intentional over- or underweight positions in equity, credit, rates, or other market betas and style bets - that are different from the policy benchmark contribute to active risk. These decisions may be arrived at due to differences in an investor’s long-term capital market assumptions, if certain asset classes are believed to offer especially attractive or unattractive prospects for the future.

Tilts: Shorter-term tilt decisions may be pursued if an investor sees a specific opportunity or threat which they wish to capitalize on by shifting portfolio exposures over the short- or medium-term.

Benchmark Mismatch: However, most investors are also experiencing active risk from a source which is not expected to add any return to the portfolio. This comes in the form of ‘benchmark mismatch’. Benchmark mismatch occurs when the benchmarks of exposures in the portfolio are different than benchmarks in the investment policy index - most commonly the benchmarks of active managers. In the same way that active manager holdings that are different from a benchmark create active risk for the investor, benchmarks that are different from policy index benchmarks generate active risk, often material in size.

On an ongoing basis, many investors discuss and quantify one, or a few, of these active risk sources in their portfolio, but most tools are unable to provide a holistic look at all sources. Verus has developed such a tool, as shown below, which allows an investor to understand the active bets they are taking and the areas where those bets are larger or smaller.

Measuring the sources of portfolio Active Risk



Source: Verus, for illustrative purposes

What type of active risk is preferred?

Our answer here is likely in line with what the reader of this paper would expect - we prefer taking positions that offer the most attractive risk-adjusted returns with consistent payoff. For 'active management' decisions, we more heavily emphasize active management across asset classes where active managers have shown a consistent ability to outperform their benchmarks, such as emerging market equities or active global equity. Greater holdings concentration and high active share are preferred attributes across many asset classes. For 'structure' decisions, we often prioritize *risk premia* that tend to deliver attractive risk-adjusted returns in a consistent manner, such as investment grade credit, which tends to overcompensate investors for both the credit default risk of the asset class as well as spread volatility. For decision-making around shorter-term 'tilts', we take into account our conviction level, the likelihood of success given historical relative performance of each exposure, and the size of the potential payoff on a risk-adjusted basis. Lastly, 'benchmark mismatch' is a source of active risk with typically no expected compensation, and therefore should be eliminated wherever possible.

The market environment can of course also play a role in determining the relative attractiveness of each active risk source - for example, rich asset pricing and mild risk premia in a generally strong economic environment, with positive market momentum, might leave investors content with sticking fairly close to their policy index and taking fewer active tilts. On the other hand, an environment of cheaper assets, higher risk premia, and market dislocations may lead investors to take greater active 'tilts', to lean into higher risk premia on a portfolio 'structure' basis, and to deploy traditional 'active management' to a greater degree.

Risk budgeting as a component of fund governance

Investor *beliefs* also play an important role in determining risk budgeting and the types of active risk to pursue. Reasonable investors may strongly disagree on topics such as fees - some of the opinion that markets are generally efficient and that ultralow management fee funds are preferred across most asset classes, and some of the opinion that highly skilled management and large alpha opportunities are available for investors who do the work and can gain access, and that this alpha comes with higher management fees. Differences of opinion exist in other areas as well, such as in the willingness to try and profit from shorter-term market dislocations and the ability of investors to benefit from short- or medium-term market tilts over time.

These types of investor beliefs are an essential input for an OCIO provider in determining which active return sources should play a greater or lesser role in the portfolio management process. Beliefs and preferences are translated into portfolio structure in the form of bounds or goalposts around active risk targets.

Do we believe an *optimal* balance of active risk exists? At Verus, we generally target an active risk budget that includes: 70% of active risk fueled by *active management*, 20% of active risk

fueled by *structure* decisions, and 10% of active risk fueled by *tilt* decisions. But this is likely one of those investment topics that is both *art* and *science*, with no single perfect answer. We believe the decision should be influenced and adjusted based on the beliefs and preferences of each investor and their own objectives.

Conclusion

The type, and amount, of risk exposure that an investor chooses to take on is one of the greatest determinants of portfolio performance and outcome. For an OCIO provider, it is *active risk* which plays a large role in driving portfolio outcomes and success. *Active risk* is generated any time that a portfolio exposure is different from the policy benchmark, and includes: traditional *active management*, long-term portfolio *structure decisions* such as beta bets (specific positions in equity, credit, rates, or other market betas) and style bets (value or growth, small-cap, etc.), *tactical tilts* meant to take advantage of short-term market opportunities, and portfolio rebalancing approaches. The amount of emphasis placed on each of these sources of active risk is a decision that should be guided by each investor, their preferences, and their objectives. We prefer taking active risk positions that offer the most attractive risk-adjusted returns with consistent payoff. While active risk budgeting should be tailored to the beliefs and preferences of each investor, as a starting point we generally target an active risk budget that includes: 70% of active risk fueled by *active management*, 20% of active risk fueled by *structure* decisions, and 10% of active risk fueled by *tilt* decisions. Active risk that is uncompensated, such as that which is a product of *benchmark mismatch*, should be mitigated as much as possible.

For more information regarding our views on active risk in OCIO portfolio management, please reach out to your Verus consultants.

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