

Financial Control Limited

THE INVESTOR

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Thought of the Month – Can bad performance get worse?

We've all heard about the random walk theory explaining how asset returns follow a "random walk" and are not predictable from one day to the next. But in practice is this true? Let's look at those bad investments we've all made from time to time. How many times has that bad stock or that bad fund suddenly spiked in performance? How many of us have held on to bad investments thinking that they cannot get any worse but in fact they do? There seems to be some kind of strange behavior among bad performers that makes them stay bad regardless of the random walk theory. What makes things worse is that brokers, fund managers, analysts, and market commentators will often say, "these stocks/funds are cheap...now is the time to buy!" Well, unfortunately we bought a long time ago when we thought they were a good buy only to find out that they were overpriced and that "now is the time to buy!" We've also got the value investors and value funds throwing their weight behind the investment saying "we've never seen prices at these levels. Fundamentally, these are the best bargains we've ever been able to find." You can see how easy it is to get caught up in this frenzy that investments are not bad performers but are great performers that can be bought on the cheap! Personally I tend to subscribe to my own theory that says "if an investment is a bad performer for several years, it will probably continue to be a bad performer, unless there has been a drastic change in the management or the market structure." I have had many occasions to test my theory with my own personal investments and found it to be quite workable in practice, to my detriment!

Why is the Sky Blue? – Why is risk management so difficult in practice?

It is easy for a firm like ours to provide risk management consulting services. The difficult part is implementation! i.e. putting theory into practice. Lest we forget that solid risk management is equally art and science, here are some kind reminders of issues that risk managers encounter on a daily basis:

- Should "spreadsheet deals" (i.e., those that will not fit into the risk management system) be allowed?
- How do we address liquidity and default risk in emerging markets on positions for which proxy historical data is extremely sparse?
- How do we estimate proxies to generate historical data for positions that have been recently issued and for which there are no obvious choices?
- Do we select a separate system that is the best in its class for each aspect of the firm's operation (e.g., order routing and execution, pricing of specific instruments, risk aggregation across instruments, PNL calculations, and settlement and cash management, etc.), or do we go with an STP solution that comes with pre-established links between all aspects of these areas and accept sub-optimal solutions in specific areas?
- Should the credit risk of an instrument be related to the possibility of default of both its counterparty/issuer and its custodian and if so, how?

- How do we assess strategy risk versus return in conjunction with leverage when traders are benefiting from cross-margining across traders and strategies?
- How can we align traders' interests with the portfolio returns in multi-trader environments when typically a fund or trading desk can only receive a bonus if the entire fund or trading desk makes money, even if specific traders generate positive returns despite an overall loss by the fund or desk?
- Despite the best efforts of mathematicians, do we feel comfortable that a certain hedging strategy will work across interest, credit, and equity risk factors in a convertible bond portfolio?
- If a system cannot properly handle a particular deal, what is the best solution to achieve correct pricing, risk management and PNL while not misleading a trader about his/her positions? Decomposing a deal can often throw off a trader, and managing it externally by using a spreadsheet can lead to various operational risks.
- The list goes on...!

As you can see, implementing a strong risk management culture does not mean that there will be no margin for error, no loopholes, and no way for traders to game the system. It simply means a culture that is designed to minimize potential losses that could arise from any of the above challenges (and others that might not be listed above) that most organisations face. One could look at this as a classic problem in operations management: perhaps a program could be developed that would determine the risk management framework to adopt that would give maximum benefit (e.g., lowest projected losses) at the minimum cost (e.g., software, hardware, time, and salaries required). In practice, a firm's internal politics, goals, and marketing strategy, combined with the thought process of key players in the risk management committee, generally act together to determine the risk management framework that is adopted.

Nourishment - What is good risk management?

It always entertains me to see risk managers complain that they "want to be more than just a policeman" or are only given authority to "check limit violations, but not set strategic risk appetite and policy". Whenever I see another blow-up similar to what happened at AllFirst Bank, Kidder Peabody, LTCM, Enron, etc., I think to myself that *perhaps* the risk management department was given the green light to not only monitor risk exposure and limit violations, but also to enjoy the more prestigious status of deciding overall acceptable risk levels, allocating risk across product lines, setting trader compensation policy, etc. And then I think to myself, what was more important to these risk managers: quantifying risk and returns, applying risk budgeting, and setting trader compensation schemes based on pre- and post- risk/return analysis or making sure that internal controls were tight and that back and middle office personnel had the skills, time, and motivation necessary to ensure that unusual trading activity would be noticed and elevated to personnel empowered to control the front office and seriously curtail or even shut down its activity if warranted?

So what is good risk management? In my opinion, here is a good starting point: a culture that not only focuses on qualitative and quantitative measures of risk exposure at a reasonable cost, but also empowers risk managers to act independently from traders and report straight to the CEO of an organisation any time unusual trading activity is noticed. More importantly, product controllers, middle office and risk management personnel have the time, skills and motivation that allow them to: i) have a great chance of noticing unusual trading activity and ii) the courage to report such activity up the chain of command with confidence that something will be done to follow up on their hunches.

Unfortunately, the short-sightedness and actions of some executives can put an institution or asset manager at greater peril – there is often talk about enhancing shareholder value through expense reductions but the hidden trade-off is less internal control and risk oversight. In other words, it is easy for shareholders to see cost savings via reduced expenses (e.g., salaries, administration costs, etc.) on a firm's income statement but how can shareholders see the benefits of increased risk oversight (i.e., how can you show shareholders that a catastrophe was averted?!)? Thus it is always very tempting for executives to cut corners in operations and risk control.

Then there are the smoke and mirrors...time and again throughout my career I have seen management of financial institutions confidently assert that their back and middle office personnel can "come to them anytime to discuss problems" or "we have an open door policy here". But on the other hand, I notice that their back and middle office personnel are nowhere near as well qualified as their front office, have no time and resources necessary to establish tight controls designed to analyze trading activity in a sophisticated manner, nor have the courage to report unusual activity beyond the traders themselves. Or perhaps the back and middle office reports issues to top management but no further action is taken (Enron's Sherron Watkins is a classic case!) In other words, the back and middle office are designed to process and report, not to analyze and curtail trading when necessary! I challenge any organisation that reads this newsletter to ask themselves whether they judge back and middle office performance on how reliable and fast they produce a daily PNL as opposed to how sophisticated their analysis is and how tight their controls are.

[Feedback](#)

As always, we greatly appreciate your comments and feedback. We realize that our ideas and information might be cutting edge, futuristic kind of stuff or mysterious in some ways. E-mail us anytime at help@financialcontrollimited.com if you would like a) for us to clarify something, b) to recommend improvements to us, or c) to just debate with us – we like philosophy especially as it relates to financial services! Or visit our site at www.financialcontrollimited.com

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These newsletters are designed to provoke thought and stimulate debate based on real world challenges that we face in our daily lives as we manage investments for ourselves and for others.