The Holy Grail: Institutional-Style Risk Management for Family Offices

Editor's Note: In this section of FON, we bring to our community articles from industry experts and advisors. The author below does not have access to FON. To be connected directly with him, please email Content Director Kristen Oliveri by clicking **HERE**.

Kristen Oliveri sits down with Samuel K. Won, the Founder and Managing Director of Global Risk Management Advisors, an independent risk management advisory and implementation firm that provides institutional-quality risk management services to asset managers and institutional investors, to discuss the nuances of risk management and how families can obtain the holy grail by having institutional-quality risk management within their family office operations.

FON: Why is the term "risk management" in everyone's lexicon and what does it mean in the context of a family office?

SW: In the aftermath of the financial crisis that began in 2008, the term "risk management" has now entered virtually everyone's lexicon. For most family offices, there are numerous risks they face as an organization such as operational risk, enterprise risk, and financial and investment risk.

An area of particular focus has been investment risk, including market risk, credit/counter-party risk, liquidity risk, and leverage risk. We see this as a significant trend, with many leading family offices increasingly interested in better understanding their investment risks and wanting to know how they can better monitor and manage these risks.

FON: What is prompting family offices to adopt more formal and institutional-quality risk management practices?

SW: As a trend, the investment portfolios of major family offices are becoming more complex and diversified. The assets they are invested in are reflecting the array of more complex offerings in the marketplace, and many families are practicing more strategic diversification to both help increase their yield and reduce the risk of their overall investment portfolio.

Added to this, the 2008 global economic meltdown unquestionably instigated a wake-up call that is still reverberating with all investors – many family offices were either directly affected or felt the chill of impact on other families or on the wider market, and this has added to the realization that, with the amount of money at stake in their family's investment portfolio, a more rigorous, and institutional-quality approach to risk managing their investment portfolios is no longer optional, but is a must-have.

As a result, family offices have now begun to emulate what some of the leading institutional investors (e.g. endowments, foundations and pensions) are doing by taking a more formal and "institutional-quality" approach to the risk management of their investment portfolio.

FON: What is institutional-quality risk management?

SW: Many people, including experienced investment professionals, believe that they understand what investment risk management is when, in reality, they do not. For example, we have found a common misunderstanding is that risk management is a discipline that nearly solely focuses on producing statistics or metrics about risk and how much money can theoretically be lost in an investment portfolio should there be a major decline in the markets or in asset prices.

This basic lack of understanding leaves many families and their advisors unknowingly following an informal and seat-of-pants approach to investing and risk management. As result, we see a number of families that employ an investment style that vacillates between two extremes—chasing returns after the fact and having a hyper-obsessive focus on capital preservation without a well thought out plan for growing their wealth in a sound manner.

Many family offices do not understand that "true" institutional-quality risk management goes well beyond simply trying to do risk measurement. In order to have institutional-quality risk management, they must first have a solid risk management framework that includes four pillars: sound risk strategy, effective risk infrastructure (people/systems), proper risk management processes and controls, and effective risk management governance. Without these "essential pillars" in place a family office can never hope to have strong risk management for their investments.

FON: What are the common mistakes that family offices make?

SW: We commonly see three types of mistakes. First, family offices can be irrationally frugal and laissez faire when in it comes to spending money for proper risk management and oversight of their investment portfolio. It does not make sense for them to be "cheap" or myopic when it comes to protecting their assets and ensuring that they have a sound investment risk management. A second common mistake is incorrectly assuming that their external investment consultant or advisor is doing something for them with regards to risk management and, therefore, that they are "covered." In fact, the vast majority of investment consultants focus almost exclusively on asset allocation and manager selection, and have neither the expertise nor resources to provide formal, much less institutional-quality risk management services. In addition, family offices often fail to consider the inherent conflict of interest a consultant or asset manager has which makes them the wrong parties to be overseeing family office risk in any case. They need a complete, aggregated and independent understanding of their investment risk across the entire portfolio—including all of their liquid and illiquid investments.

The third common mistake that we see families making is that they assume that they are doing risk management because they do a few things "around the margin." For example, some family offices may have an Excel spreadsheet or some simple software that they use to track returns or look at volatility. Therefore, they assume that they are already doing risk management. For these types of families, we generally recommend a Risk Diagnostic Evaluation ("RDE") that compares what a family is currently doing for investment risk management against best practice standards as well as against leading peers in the investor space. We find that this type of comparative "gap analysis" can greatly help a family to understand that what they are presently doing for risk management is superficial and insufficient; and, in reality, does not meet the institutional quality litmus test for risk measurement, risk monitoring and risk management processes, controls and risk governance.

FON: What are the key considerations for family offices that want to do more formal risk management?

SW: We strongly believe that the key consideration for a family office should be to have actionable risk management. The starting point for a family should be to put in place a sound risk management framework that includes key elements such as an investment policy statement that reflects the family's approach toward risk management; risk policy guidelines that define the family's tolerance levels and budget for risk; and risk management policies and procedures, as well as risk management processes and controls that operationalize how risk management will be executed as part of the family's key investment processes in areas such as asset allocation, re-balancings, and manager selection and redemptions. In conjunction with a solid risk management framework, a family office needs robust risk metrics and risk management decision-analysis so that they can best manage their investment risks. An adage that we like to share with families is to remind them that they cannot manage their investment risks if they cannot measure and monitor these risks.

One of our major recommendations is that risk metrics alone are meaningless if they are not used as part of an overarching and solid risk management framework that includes sound risk management strategy, processes, controls and governance. Only then, can a family office hope to produce superior risk adjusted returns over different market cycles and have an investment program that is truly sound, repeatable and sustainable over the long term.

Samuel K. Won is the Founder and Managing Director of Global Risk Management Advisors, the leading independent risk management advisory and implementation firm that provides institutional-quality risk management services to asset managers and institutional investors as a managed service. He has over 25 years of experience in risk analysis and reporting, risk infrastructure implementation, risk strategy, capital markets, trading and portfolio management at major global financial institutions, asset management firms and the government.

My dashboard Sign out
My Groups
My Library
My personal profile
Messages
Add a blog post
Sign out

Search site
Search
Search by topic
Search by topic
For tips on how to improve your search click here.

Help

Need help? Have a research piece, article or discussion topic to share? If so, please contact:

Content Director North America
Kristen Oliveri
+1 212 224 3658

Director
Lara Park
+44 (0)207 779 8696

Membership Manager
Anna Carden
+44 (0)207 303 1754

Director
Charlie Floyd
+44 (0)207 303 1734

Executive Director
Usha Bhate
+1 212 224 3429

Masquerade
Go
Enter the username to masquerade as.