Risky business

A combination of sweeping regulatory changes and pressure from large institutional investors has resulted in alternative asset managers providing more granular details about investment holdings and the associated market, credit and liquidity risks in their portfolios. But what does this mean for family offices' risk management protocols?

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Q What portfolio and risk information is available to family offices today?

A As a direct by-product of the financial crisis and with the passage of Dodd- Frank, all alternative asset managers exceeding the $150m threshold of regulatory assets under management (RAuM), must now report Form PF to the US SEC.

In Form PF, there is quite a lot of useful information that could be beneficial to investors in assessing the investment holdings in a fund manager's portfolio, such as their exposure to derivatives, counterparty exposures, liquidity profile and the fund's sensitivity to drawdown from stressing various market factors.

Naturally, some savvy institutional investors are asking their fund managers to provide them with a copy of the manager's Form PF as part of their due diligence process. Many fund managers are reluctant to share this information, but we are seeing a change in this trend; some fund managers now allow investors to view their Form PF at the fund's offices or offer redacted information on request.

Similarly, the European regulators have ratified AIFMD (Alternative Investment Fund Managers Directive), which not only requires fund managers to provide detailed portfolio and risk information and data, but also mandates an independent risk management function and more detailed disclosures to investors.

Q What should investors do with this new portfolio and risk data?

A The new enhanced portfolio and risk transparency data now available to investors can be extremely useful in helping investors to not only obtain a picture of the risk profile of any specific risk holdings in an asset manager's portfolio, but also to get an aggregate view of the investment risks in their entire portfolio of both traditional long only and alternative investments.

If the institution has done this risk data aggregation and analysis properly, it should enable the institution to compare various asset managers' risk and performance versus another manager on an 'apples-to-apples' basis, so they can ascertain what the asset managers' risk adjusted performance has been and how the asset manager is performing against relevant benchmarks.

Q Why is it not enough to simply be doing risk measurement?

A We have seen a number of institutions fail in taking this new data from their asset managers, and then do the necessary risk measurement and risk management on their own. Their failure stems from not only their lack of risk management staff and risk systems, but because these institutions do not possess the proper risk management framework that is necessary for taking new risk and portfolio information to make it actionable and integrated into the overall investment process.

Q What are the key elements of a sound risk management framework?

A For an institution to take full advantage of the new risk and portfolio transparency, it is essential for them to possess a proper risk strategy including risk management processes, controls and governance, as only in this way can they have an integrated and effective investment process. A sound risk framework requires that an institution's investment policy statement clearly spells out their risk management approach and the specific responsibilities of the staff and board for risk management.

Ultimately, institutional investors should ask themselves the following three questions:

- Do we have an aggregate picture of the risk profile of our entire investment portfolio of both liquid and illiquid investments?
- Are we able to measure and monitor our asset manager's risk adjusted performance?
- Do we have a clear risk defeasance plan when the next financial crisis occurs?

If the answer to any of these questions is 'no', then the firm should be concerned about potential fiduciary risks. More importantly, they should be concerned about their large voids in risk management that exist, and the fact that the new transparency is available to them will be of no value.