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RESEARCH

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# The Odyssey of Risk

## Find Your Compass

To paraphrase Mark Twain, history may not repeat itself, but it does rhyme. From that perspective, the lyrics of 2008's liquidity crisis and market collapse were full of familiar refrains. Looking back at prior financial crises (e.g., Panic of 1873, Crash of 1929, Black Monday of 1987, Long-Term Capital's blow-up in 1998, or the tech bubble popping after Y2K) reveals similar episodes of investor complacency, combined with greed, that conclude with fear and ruin.

### Déjà vu All Over Again

Beginning each new chapter of risk taking, investors pledge to cast off bad habits. To prevent recurring mistakes, they also erect new defenses in risk management and policies, like lighthouses warning of shipwrecks past. After a cathartic process of repairing portfolios and foreswearing unwarranted risks, venturesome investors set sail again when turbulent seas of capital markets calm down and the economy appears to recover. Then the Sirens' song of new investment opportunities can be heard again, drawing buyers subtly to enticing shores of rocky risk. Complacency, greed, fear, rinse...repeat.

### Top 10 Lessons Learned

How can fund sponsors, like Homer's Odysseus, somehow tie themselves permanently to their ship's fiduciary mast, sail past these alluring—but dangerous—risks and still achieve long-term investment objectives? Using a trusted compass of investment truisms, investors can chart a course to avoid unnecessary risks. Based on coordinates surrounding past investment mistakes, Callan highlights what we consider to be the top 10 lessons for managing risks and the next steps fund sponsors may want to consider. Each guideline represents common sense that is often forgotten when markets get frothy or decoupled from fundamental values.

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### **About Callan Associates**

Founded in 1973, Callan Associates Inc. is one of the largest independently owned investment consulting firms in the country. Headquartered in San Francisco, Calif., the firm provides research, education, decision support and advice to a broad array of institutional investors through five distinct lines of business: Fund Sponsor Consulting, Independent Adviser Group, Institutional Consulting Group, Callan Investments Institute and the Trust Advisory Group. Callan employs more than 170 people and maintains four regional offices located in Denver, Chicago, Atlanta and Florham Park, N.J.

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### **About the Callan Investments Institute**

The Callan Investments Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

## Lesson 1: Assume liquidity is not there when you need it.

The painful reality of 2008 was that virtually all asset classes, besides Treasuries, froze to some degree. As fear and panic seized the marketplace, no buyers emerged when everyone was scrambling to protect their capital. Equities, credit, real estate, hedge funds and even many money market funds exposed to non-Treasury paper could not be sold for cash except with unacceptable markdowns. Access to cash, whether via secured financing or short-term risk-free paper, has an explicit cost or opportunity cost. Either way you pay for it at some point.

**Next Steps:** To prepare for the next liquidity crisis, investors should define their ongoing short to medium-term liquidity needs and budget for them accordingly. This process identifies the reliable sources of cash flow from investments (i.e., interest income, stock dividends, maturing high-grade paper) that do not depend on selling long-term capital at risk, like long-duration credits or equities. This risk-budgeting exercise should be an integral part of a strategic asset allocation policy, however dynamically adjusted, to reflect current market conditions.

## Lesson 2: Keep the double-edged sword of leverage away from vital organs.

As investors learn in each financial crisis, leverage is a sharp-edged tool—not a magic wand for higher return. Many leveraged investors who

rationalized yesterday's trade based on easier credit are now facing insolvency as market values of financed investments have fallen while loans are coming due. Witness last year's impact on such investors in relatively liquid markets and now what is happening in the more illiquid markets like private equity and commercial real estate. If lenders cannot extend credit based on current values, excess leverage can forcibly shorten time horizons. Without easy credit today, many previous market participants are gone, leaving surviving bids far below fair market value. As attributed to John Maynard Keynes,<sup>1</sup> "The market can stay irrational longer than you can stay solvent."

**Next Steps:** In most markets today, we can expect cash transactions to drive fair value. Nevertheless, leverage can still comfortably carve out some attractive returns in the right hands. Investors should observe some general rules of thumb. When looking at loan-to-value metrics, predefine a comfortable margin of safety (not simply whatever the lenders will accept in a time of easy credit) so that unexpected market sell-offs and worsening credit conditions do not force a sale of the underlying investment. For example, too much exposure to portable alpha strategies when the overlaid beta was declining dramatically led to forced selling of the underlying "alpha" engine. Terms of financing should also generally match the expected time horizon of the investment or trade. Expecting rational credit markets at the end of that time horizon was the alluring trap for many caught in today's predicament.

<sup>1</sup> [www.maynardkeynes.org/keynes-the-speculator.html](http://www.maynardkeynes.org/keynes-the-speculator.html)

### Lesson 3: Systemic equity risk is not diversifiable.

In a market like 2008 where risk aversion was everywhere, there was no place to hide, leaving one to question the value of diversification. Despite popular theories of decoupling, both U.S. (Russell 3000: -37.31%) and non-U.S. stocks (MSCI EAFE: -43.38%) declined in 2008. Large cap (S&P 500: -37.00%) and small cap stocks (Russell 2000: -33.79%) fell almost in lockstep, shedding any illusion of diversification in tough markets last year. Value (-36.25%) and growth (-38.44%) styles also suffered the same fate under pressure, as measured by the Russell 3000 Indices. Since active extension products, like 130/30 strategies, involve leverage, investors here simply magnified whatever active risks were being taken last year and suffered accordingly.

**Next Steps:** As liquidity returned to the market in 2009, the active risks that hurt investors in 2008 rewarded them again. Looking ahead, don't give up on diversification. With the market focusing more on fundamentals, long-term diversification by geography, capitalization and style will more likely pay off. However, the short-term visibility may be cloudy. More severe headwinds in the outlook for equity—the bottom rung of all capital structures—are possible. Given the inherent risk of systemic equity exposure, fund sponsors less able to endure such risk should consider strategically lower allocations to equities, however diversified. To define one's risk budget, each investor's liquidity needs and liability structure will be the key considerations—not simply someone else's asset allocation as a key reference.

### Lesson 4: Bond portfolios involve more than interest rate risk.

Active risks of fixed income today have become much more complex than those of traditional corporate credits. Last year investors discovered the toxic combination of embedded leverage and illiquidity in structured products and other asset-backed securities. Investors became complacent dealing with these risks, relying upon rating agencies, who in turn relied upon the issuers to define the opaque risk models. Without investor discipline restraining the borrower, inappropriate leverage grew in these capital markets, which later collapsed. Strategic overweights to higher yielding credits did not help active bond managers either. In 2008, the average Callan Core Bond (+0.76%) manager dramatically lagged its Barclays Aggregate benchmark (+5.24%), before fees. While Core Bond (+4.22%) managers have recovered well versus the benchmark (+1.90%) as of June 30, 2009, confidence in active managers to add value with low tracking error will take longer to recover.

**Next Steps:** For an investment designed to be the reliable ballast of one's total portfolio, fixed income still requires thoughtful handling. Investors cannot take for granted the certainty of cash flows, quality of assets backing the debt and reliable supply of lenders bidding for paper in the secondary markets. Looking beyond nominal credit ratings, today's successful investor needs the skill and discipline to examine a credit vehicle's fundamentals and follow the money behind it. To be an effective portfolio diversifier, fixed income portfolios should provide insurance and

be a source of capital in bad economic times so that investors can be patient elsewhere in the portfolio.

## **Lesson 5: Illiquidity premium can be negative.**

When alpha, or excess returns over a benchmark, became difficult to find in the more liquid markets, investors—particularly in the last five years—sought above-average profits off the beaten path in areas like private equity, hedge funds, real estate and infrastructure. Well-regarded endowments, like Yale and Harvard, trumpeted such alternative strategies as the key to success for long-term investors. Allured by a perception of a structurally positive premium in the private versus public markets, imitators of the endowment model rushed ashore in a massive wave. When the tide of easy credit suddenly withdrew, investors, including Yale and Harvard, were caught in the ensuing liquidity crunch. Visions of being compensated with a positive illiquidity premium quickly disappeared. Without cash available elsewhere, avid fans of alternative strategies are now struggling to meet their basic spending needs or other liabilities. Private equity investments were especially painful—contractual commitments forced investors to add more capital, exacerbating the “denominator effect” where falling liquid market values pushed targeted private equity allocations beyond acceptable ranges.

**Next Steps:** Last year’s systemic withdrawal of liquidity is not unique, except perhaps to the degree it is visible and fresh in the minds of investors today. When allocating to illiquid investments, investors should prepare meaningful cushions of liquidity across their portfolios. One key

premise behind hedge funds is to be a liquidity provider in the capital markets, buying when others are selling and selling when others are buying. During a liquidity crisis, treating hedge funds like cash undermines that objective. Consequently, such investors should plan for withdrawals in good times and contributions in bad. For private equity and other investments invoking capital calls upon their investors in the future, be wary of aggressive schedules aiming higher to meet targeted allocations sooner.

## **Lesson 6: Hedge fund alpha is scarce, expensive and often temporary.**

While hedge funds may target an attractive premium over LIBOR or Treasury bills, the quest for such absolute return is sometimes very unrewarding, even among the best investors. Whether focused on fundamental, relative value or momentum-driven strategies, a diversified hedge fund portfolio will likely contain a myriad of equity, credit and other more exotic risks, along with the occasional dollop of leverage and illiquidity. Not surprisingly, even well-regarded hedge funds got clobbered in 2008 with these systemic risk exposures. Last year’s most profitable trade was being short equity or credit risk—a position not ordinarily viewed as a profitable, long-term strategy. Normally, being long systemic risk factors, however tactical or strategic, yields positive results. The actual alpha of hedge funds is a fraction of total returns when distilled from embedded market risk exposures. Given an incentive fee structure based on net profits generated, the opportunity cost for hedge fund managers is still cash. While incentives do exist to take undue risk, virtu-

ally all hedge fund managers have personal money invested alongside their investors, helping to keep managers focused on finding alpha or at least preserving cash, not just beating a declining index.

**Next Steps:** Despite popular representations, hedge fund investors should not expect bond-like performance. Although volatility may be similar to bond portfolios in normal markets, a hedge fund portfolio is not a fixed-income substitute. Given the myriad of opportunistic risks and incentives to manage those exposures, hedge funds still complement traditional long-only stock and bond portfolios. To that end, a hedge fund allocation today is compelling and should be meaningful. Otherwise why bother? However, a handful of systemic concerns suggests a limit to any hedge fund allocation. Hedge funds have real capacity constraints, as the capital markets cannot support unfettered hedge fund growth no matter how benign the market factors might be. The amount of alpha available does not grow with each dollar added to pursue it. Another allocation-constraining factor to consider is the unexpected risk of adverse government actions—like last September’s short-selling ban. Finally, the investor’s infrequent access to hedge fund liquidity also serves as a warning not to allocate too heavily to this “asset class.”

## Lesson 7: Securities lending is not a free lunch.

A program of lending securities to earn extra income involves leverage, illiquidity and investment (e.g., credit, duration) risks. While the lend-

ing agent often indemnifies the lending fund against losses arising from operational errors due to borrower default, they do not generally indemnify for losses arising from the reinvestment of cash collateral. That is, if the lender earns a lower return on the collateral than the rebate rate, there will be an “investment loss” on the transaction. In 2008, an unexpected degree of risk was “discovered” in collateral reinvestment pools.<sup>2</sup> Securities lending programs that inappropriately assumed liquidity was within reach for higher yield suffered material losses when short-selling activity dropped and spreads widened suddenly. In particular, the use of higher-yielding structured products that were difficult to evaluate but rated investment grade was a key mistake in these collateral pools. Rating agencies methodically underestimated the systematic risk of collapsing real estate and other asset values backing these structured products.

**Next Steps:** According to Callan’s 2009 Securities Lending Survey,<sup>3</sup> cash collateral reinvestment losses ranked as the top issue for institutional investors engaged in securities lending in 2008 and the majority of respondents intend to use the most conservative collateral reinvestment guidelines (overnight Repo and Treasury investment only) going forward. To be prepared with adequate margins of capital, investment guidelines for securities lending participants should dictate very high quality, liquid and transparent instruments for collateral investment. Such guidelines should also carefully address how to manage the risk of asset liability mismatch. That is, liquidity provided to investors should be consistent with the collateral investment program’s duration risk.

2 [www.top1000funds.com/editorial/spotlight/institutions-review-securities-lending-programs.html](http://www.top1000funds.com/editorial/spotlight/institutions-review-securities-lending-programs.html)

3 2009 Callan Securities Lending Survey: U.S. Tax-Exempt Institutional Investors, p. 9 and 14. July 2009.

## Lesson 8: Rebalancing only works with liquidity.

Another popular “free lunch” for fund sponsors is a disciplined rebalancing process. At times when certain investments rise above targeted levels as others fall below, rebalancing programs dictate a systematic or opportunistic process of buying low and selling high. To be effective though, transaction costs must be reasonable. In the turmoil of 2008, fund sponsors found that they had “spent” their liquidity that could have been used to meet rebalancing guidelines. Inadvertently, cash was tied up in capital call commitments for private equity, frozen equity index funds caught by gated securities lending pools and bond portfolios with too much untradeable structured product.

**Next Steps:** Investors had to postpone or limit their rebalancing programs to avoid extraordinary costs until the needed liquidity returned. Fiduciaries should document the decision to postpone rebalancing. As liquidity returns investors can then implement any necessary rebalancing or transition. Given the wildly divergent views on the economic outlook and their potentially volatile effects on market prices, adopting wider rebalancing ranges, however temporary, may be appropriate. Consider rebalancing strategies using exchange-listed futures. One such strategy is to buy S&P 500 futures and sell Treasury futures, or vice versa. Even in volatile markets, trading costs for such futures can be significantly lower than selling securities in the cash markets.

## Lesson 9: Popular ideas usually suffer unpopular endings.

Just because everyone is doing it does not mean a prudent investor should follow suit. Before last year’s experience, popular thinking discounted the downside of leverage, illiquidity, equity and credit risks. Today, responding to what is being sold now in 2009, fund sponsors are considering new strategies that seem compelling.

For example, “opportunistic investing” promises to take advantage of investments beaten down in the 2008 sell-off. Last year’s imbalance of sellers created greatly depressed values across virtually all asset classes. Tactically, investing in such distressed assets seems like a smart contrarian approach, except when everyone including the retail investor is considering it. In contrast to a more disciplined or systematic process of rebalancing, opportunistic investing involves more discretion on when to buy and involves the risk of being in cash when markets run away from the investor. In fact, with equity markets already up over 50% or more since their March lows and credit spreads back down to levels before the Lehman bankruptcy, the low-hanging fruit available to investors in a V-shaped recovery is arguably already gone. If the massive monetary and fiscal stimulus programs fail to offset the deleveraging effect of a less spendthrift consumer, making opportunistic investments today will likely be painful to the next investor lacking experience and resources to discern real value.

**Next Steps:** If the recovery becomes L-shaped, does it make sense to implement these new

ideas, however enticing, given what is priced into one's existing equity, fixed income and alternative investments? This dramatic year-to-date market recovery has given investors a chance to redeploy risk or take it off the table. If an opportunistic investment does not rely on positive leverage, liquidity, equity or credit risk premium to yield an acceptable return, then the trade makes more sense today. Otherwise, today's fragile economic recovery suggests a high probability that today's new opportunistic investors will get a chance to learn the lessons of last year's unfortunate investors.

## **Lesson 10: CIOs and boards don't last as long as investment decisions.**

Like Keynes' view on insolvency risk, markets can misbehave longer than fund sponsors can stick to their decisions. The reality for fund sponsors is their boards or investment committees often turn over their memberships. Similarly, Chief Investment Officers (CIOs) working with these boards or committees often seek more lucrative career opportunities in the investment manager

community after building a credible resume implementing alternative strategies. These moments of organizational instability and institutional memory loss have the potential effect of leaving existing investment ideas or managers without key sponsorship. Of course, investment ideas especially at risk for termination are those at the bottom of their investment cycle or style—most likely, just before they are poised for recovery. Adding to the dynamics of this decision risk, switching consultants is another catalyst for either thoughtfully-timed or poorly-timed changes in asset allocation and manager decisions. Are we moving from yesterday's discarded fad to today's popular new gadget? Or is this really a contrarian move to reap better returns?

**Next Steps:** To better manage decision risk, more education and better communication—for example, on expected performance patterns—can improve fund governance. If different people with the same qualifications were on the board or sitting in the CIO seat, would the decisions be different, given the same facts and circumstance? Ideally, investment decisions and strategic policy will outlast the individual sponsors or consultants recommending them.

## Conclusion

As Warren Buffett is fond of saying about overexposure to known risks,<sup>4</sup> “You only learn who has been swimming naked when the tide goes out.” While we may snicker at the embarrassment of others, navigating waters too close to rocky shores can render painful lessons to anyone tempted by a more exciting experience. Indeed, when the Sirens’ song for travelers to risk a clos-

er look seems the most compelling, it is likely because the second-to-last investor has joined their chorus. That’s the time to recognize your stated points on the compass and stay the lonely course. Places without a well-rehearsed crowd beckoning travelers ashore are much safer and rewarding destinations.

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4 [www.berkshirehathaway.com/letters/2007ltr.pdf](http://www.berkshirehathaway.com/letters/2007ltr.pdf)

## Author



James C. McKee, Senior Vice President and Director, the Hedge Fund Research Group. Jim specializes in hedge fund research addressing related issues of asset allocation, manager structure, manager search, and performance evaluation for Callan's institutional clients. Jim is a shareholder of the firm.

Jim joined Callan Associates in 1989. Prior to his career at Callan Associates, Jim worked with the Pacific Stock Exchange (PSE) from 1982 to 1989. Until 1985, Jim worked on the PSE's options trading floor. Thereafter, as manager of the PSE's securities research department, he was responsible for developing and monitoring new stock, bond, and option listings.

Jim earned a B.A. in Economics/Environmental Studies from Dartmouth College in 1982. He received his M.B.A. in Finance from Golden Gate University in 1987. His graduate studies focused particularly on publicly traded securities and capital markets.

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## **Callan Associates**

### **Corporate Headquarters**

101 California Street  
Suite 3500  
San Francisco, CA 94111  
1.800.227.3288  
1.415.974.5060

### **Regional Consulting Offices**

#### **Atlanta**

300 Galleria Parkway  
Suite 950  
Atlanta, GA 30339  
1.800.522.9782  
1.770.618.2140

#### **Chicago**

120 N. LaSalle Street  
Suite 2100  
Chicago, IL 60602  
1.800.999.3536  
1.312.346.3536

#### **Denver**

1660 Wynkoop Street  
Suite 950  
Denver, CO 80202  
1.303.861.1900

#### **New Jersey**

200 Park Avenue  
Suite 230  
Florham Park, NJ 07932  
1.800.274.5878  
1.973.593.8050

[www.callan.com](http://www.callan.com)