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Managing Risk: Q&A with David Iverson

David Iverson, Head of Asset Allocation for the Guardians of New Zealand Superannuation and member of the Brandes Institute's Asia-Pacific Advisory Board, recently shared his thoughts on investment risks. Iverson wrote Strategic Risk Management: A Practical Guide to Portfolio Risk Management *in 2013. Here, he shares key ideas from that book and offers insights on current risks and how to address them.*

Q: You mentioned that risks need to be identified, understood, measured and managed. What is the greatest risk you see for investors now and how can they manage it?

Iverson: In my book, I create a framework for linking risks to investment decisions. The greatest risks I see at present are:

A. Investment beliefs changing with current market performance. Investment beliefs should provide a consistent way of thinking about markets and how they work (or at times do not work). Having a clear set of core investment beliefs helps investors avoid engaging in strategies that seem to work—and then abandoning them when they do not.

Often, market movements over the preceding few years tend to have too great an influence on investment strategies being adopted. Lately, equity markets have done extraordinarily well and without well-founded investment beliefs, there is a risk investors overweight equities at the wrong time.

We have seen similar behavior regarding active and passive management. Many investors re-evaluated active management after the global financial crisis in 2007/08 with many opting for passive management. While re-evaluating investment beliefs is necessary, there is always a risk that any change to beliefs is reactive and solely a response to poor (or good) recent performance.

B. Factor frenzy. Somewhat related to the previous risk is the frenzy of factor-focused investing. There are so many, in fact too many, articles in the investment press on new risk factors or describing how the old ones are performing.

Executive Summary

- Don't allow recent, short-term market movements (good or bad) to alter investment beliefs that were established to guide long-term decision making.
- Look before you leap into factor-based investing. Understand the principles behind these approaches.
- Evaluate short-term results within a longer-term context; what is driving recent performance? Are shorter-term returns simply noise or indicative of a potential issue?
- Be mindful of private equity allocations, given where we are in the investment cycle.
- Value investing has shown good, long-term results. The challenge is to stick with it during its inevitable periods of underperformance.

The risk is two-fold. First, the irresistible desire to join in this investment trend without understanding, and second, the tendency to search out and add new factors, however unfounded. The late Stephen Ross, founder of the Arbitrage Pricing Theory, urged investors to step back and "…think a bit about the economic foundations of this effort."[1]

While risk factors that influence and describe market returns can help with our intuitive understanding of the market, the proliferation of factors can be undisciplined and confusing. The risk is investors jump on this investment bandwagon only to be disappointed by the inevitable poor returns such strategies will bring in the future and without full appreciation or understanding what the strategies entail and are capturing.

Q: You wrote about the importance of measuring short- and long-term results. What is the best way to do this?

Iverson: Investment performance reporting is essential to communicating information to the board or investment committee. Long-term results should always be the focus while keeping an eye on short-term results. Short-term results cannot be ignored, but they are inherently noisy. There may be important information in shorter-term results that indicate a problem. I think the best way to measure short-term results is:

A. Context: shorter-term results should be put into a longer-term context. So rather than presenting monthly or quarterly returns, only show rolling 5-year returns which are updated pursuant to the reporting cycle (e.g., quarterly).
B. Expectations: monitor short-term results against the expected distribution of results. Outliers can then be used as triggers to further investigate whether such results are due to an underlying problem or whether such results are due to the inevitable noise expected over short periods.

Q: You wrote that "…no trading rules based on initial PE [price/earnings] ratios outperformed a simple buy-and-hold strategy" between 1871 and 2002. While it's been a much, much shorter time frame, value has been out of favor for several years lately. What is your view toward value investing in the short term and over the longer term?

Iverson: The quote specifically relates to the ability of simple PE ratio metrics at the market level (such as the S&P 500 Index) at predicting future market returns. In contrast, PE ratios across companies have more predictive power. Value stocks (low PE ratios) have tended to outperform growth stocks (high PE ratios).2 In this sense, value investing is worthwhile, but it comes with risks. The risk is that a value strategy, like a simple PE ratio score,

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[1] Ross, Stephen A. "Factors—Theory, Statistics, and Practice." *The Journal of Portfolio Management*, 43.5 (2017) pp. 1-5.
[2] For example, the MSCI World Value Index outperformed the MSCI World Growth Index from Dec. 31, 1974 to Dec. 31, 2015. A hypothetical $100 investment in each index over that period grew to $686,784 in the MSCI World Value Index vs. $364,328 in the MSCI World Growth Index, according to MCSI data via FactSet. This reflects cumulative performance. The performance shown does not reflect the effects of taxes, fees and expenses, which would reduce the ending balances if included. Past performance is not a guarantee of future results. One cannot invest directly in an index. This hypothetical example is for illustrative purposes only and does not represent any specific investment. Actual results will vary.

may not always provide superior results. We've experienced just such a period—value stocks have underperformed over quite a few years. Such a prolonged period of underperformance does not mean a value strategy should be abandoned, but is part of the risks of such a strategy.

The longer-term results are very supportive of value investing over time and across countries. The real challenge is to stick with a value strategy through such periods. Unfortunately, there are no reliable ways to time when to be in a value strategy versus a growth strategy. Again this comes back to having supportive investment beliefs and a long-term focus.

Q: What are the biggest risks with private equity?

Iverson: Private equity faces a head wind of valuation at this stage of the cycle. The illiquidity risk premium inherent in private equity is at risk of being overvalued. This is being driven by broader economic central bank liquidity provisions and resulting allocations to illiquid asset classes such as private equity.

Q: What suggestions would you share on how to get defined contribution (DC) plan participants to take more risk—and give themselves a better chance for higher returns over time? As you note, they tend to invest in "low risk" portfolios, exposing themselves to longevity and/or inflation risks.

Iverson: DC plan design is the key here. DC plan fiduciaries should establish the risk levels that make the most sense given the demographics of the underlying members. Age of the member provides some indication here but is in no way determinative.

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Where the DC plan offers member investment choice, the default option should reflect the average member's investment risk profile. The investment options (higher and lower risk options) would allow members that differ from the average to choose those that suit their risk profile and retirement needs. As is well known from behavioral economics, getting the default option right is essential, since the majority of members tend to stick with the default option.

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Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. For example, over a 20-year period, there is one 20-year rolling period, eleven 10-year rolling periods, sixteen 5-year rolling periods, and so forth.

The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

The MSCI World Value Index with gross dividends captures large and mid cap securities across developed market countries exhibiting value style characteristics, defined using book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI World Growth Index with gross dividends captures large and mid cap securities across developed market countries exhibiting growth style characteristics, defined using long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.

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