EDITOR'S CORNER

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What Risk Matters? A Call for Papers!

The finance literature bursts at the seams with measures of risk and arguments favoring one definition of risk relative to another. Academics tell us that the most important risk in an investment portfolio is some variation of standard deviation. Practitioners "know" that the greatest peril is the risk of being wrong and alone. This danger is sometimes called "maverick risk."

Question: Which of the following measures of risk is the most important?

Quantitative Risk Metrics	Qualitative Risk Metrics
• Standard deviation or variance?	• Maverick risk?
• Kurtosis?	• Opportunity cost?
• Probability of loss?	• Violation of account guidelines?
• Probability of liability shortfall?	• Violation of regulatory guidelines?
• Downside semivariance?	• Retroactive changes in guidelines?
• Value at risk (95 percent confidence)?	• Adverse surprise in part of a portfolio?
• Tracking error versus benchmark?	• Surprise from a single failed asset?
• Tracking error versus liabilities?	• Exceeding risk tolerance of new management team?
• Peer-group ranking, tracking error?	

Answer: Whichever one hurts us, which we cannot know until after the fact.

The Danger of Maverick Risk

Many of the worst errors in investment management can be traced to an industrywide focus on maverick risk. Most of us work as agents, not principals, investing "other people's money." As such, we fall prey to the Keynesian dictum that it is more acceptable to fail conventionally than to succeed unconventionally.

Keith Ambachtsheer (2002), citing the database of Cost Effectiveness Measurement, has reported that the tracking error of the typical U.S. pension fund's normal policy portfolio versus the performance of the liabilities it is intended to cover averages 18 percent. In contrast, the tracking error of the actual fund relative to its normal policy portfolio averages only 3 percent. That normal policy portfolio clusters around 50/50 to 70/30 equity/debt for most pension funds, with little regard to the maturity of the company's work force or the health of the fund sponsor. Apart from the perils of maverick risk, no business reason prescribes that a fund should exhibit six times as much tracking error relative to its liabilities as relative to its policy benchmark or peers.

In the first quarter of 2000, just before the bubble burst, Ron Ryan and I wrote a paper titled "The Death of the Risk Premium" (see Arnott and Ryan 2001), in which we made the case that stocks were priced at a level that virtually assured a lower long-term internal rate of return for stocks than for government-guaranteed Treasury Inflation-Indexed Securities (or TIPS). Did we recommend that our clients liquidate all of their stock holdings? Of course not. Would such a choice (even without the blessings of hindsight) have been risky based

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on any of the "quantitative risk metrics" listed? Of course not, except for tracking error relative to an equity-biased benchmark. Would such a choice (even with the blessings of hindsight) have been risky based on any of the "qualitative risk metrics"? You bet.

The risk that would have made this counsel problematic (for our clients and for us) is maverick risk. Most of our clients would have been fired for recommending the liquidation of all stocks in an institutional portfolio. For those who were successful in such a recommendation, the move would have been a "zero-tolerance decision," in which a decision must succeed or else the manager is fired. Any investor who makes a decision that exceeds the risk tolerance of the assets' owner is not living up to the obligations of a fiduciary. And that risk tolerance is often defined after the fact on the basis of whichever metric of risk provides an adverse shock.

No decisions are infallible. Decisions that leave an investor alone carry the inherent risk of being both wrong and alone. If an investor is wrong and alone, a strong likelihood is that the assets' owner will not have the patience to see the investment decision through. The decision, even if correct in the long run, will be reversed before it can succeed. Worse yet is that, although we know *ex ante* that any of several risks could turn out to matter, we cannot know which risk will hurt us until the damage has been done.

Another example of maverick risk is telling people what they do not wish to hear. A contrarian view is often not accepted until it has long been shown to have been correct and has, therefore, lost its relevance. To earn rewards by telling people what they want to hear is far easier, even if the message is wrong, than telling them what they do not want to hear, even if the message is correct.

Why the Subtitle "A Call for Papers"?

The simple fact that the risk that matters is the one that hurts us has received remarkably little attention in the literature over the years. Much of the finance literature is devoted to quantitative metrics for risk. Precious little has been devoted to the qualitative measures. Yet, human behavior demonstrates that qualitative measures of risk have far more influence on investment choices than quantitative metrics. The topic of maverick risk is clearly underexplored in the literature, although Dean LeBaron touched on the issue in his seminal (and Graham and Dodd Scroll-winning) 1983 *FAJ* article, "Reflections on Market Inefficiency."

Moreover, much of the finance literature is devoted to the individual metrics of risk—studying them or arguing for one relative to another. But we know that multiple metrics of risk are necessary. The mathematics of optimizing to a composite quadratic risk function, which is a weighted combination of multiple metrics of risk, is trivial. Yet, the literature has left the study of multiple metrics of risk largely unexplored.

In short, academics and thoughtful practitioners have done remarkably little work on quantifying the results of portfolio management against multiple measures of risk or on the role of maverick risk in investment decisions and investment errors. These topics deserve serious scrutiny—which brings us back to the call for papers.

References

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