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VOLATILE MARKETS REINFORCE NEED FOR RISK AND LIQUIDITY MANAGEMENT

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Periods of market volatility, as we have experienced in 2023, often prompt families to review their investment strategy and implementation decisions to ensure they are aligned with their long-term objectives. How well a family is managing risk should be a key part of this review.

Risk is most effectively managed using a framework that accounts for potential risk at every stage of the investment process. It encompasses three main components: strategic risk, implementation risk, and portfolio monitoring and communication.

Strategic Risk

Strategic risk is centered around knowing one's objectives and expectations. Understanding risk tolerance, properly setting (and adjusting) return objectives, and aligning those expectations with an asset allocation strategy will help position the portfolio for success, especially during inevitable periods of market volatility.

The formulation of well-aligned portfolio objectives should be followed by the creation of an Investment Policy Statement, a well-defined governance process, and agreement on realistic expectations for performance with relevant and meaningful benchmarks to evaluate the portfolio's ongoing success.

Implementation Risk

Most frameworks for measuring and monitoring risk center on implementation—how the portfolio is invested relative to the strategic asset allocation. Family investors should ask several key questions to make sure they are comfortable with the level of implementation risk in their portfolio, especially as it relates to liquidity and investment manager considerations.

Implementation Risk: Liquidity

Liquidity management is perhaps the most important element of risk management. Failing to plan sufficiently for the liquidity needed to support spending, taxes, capital calls, and outsized distributions can result in the inopportune sale of assets, or even permanent loss of capital.

To ensure adequate liquidity, portfolios should be periodically stress tested across a range of potential market environments. By bracketing today's portfolio into highly liquid, semi-liquid, and illiquid assets, families can estimate asset values of the liquid pool amid a severe downturn. Comparing the post-downturn liquid pool to projected annual spending and capital call requirements will provide a sense of liquidity risk. Families should also examine the assumptions underpinning their portfolio, such as foreign currency risks and potential impact to income from dividends or an operating business, to understand how their total ecosystem might be impacted by an economic downturn.

In addition to stress testing, regularly running private investment commitment modeling, staying aware of manager liquidity windows (including lock-ups and side pockets), and having a line of credit in place to manage transactions are all steps families can take to maintain a healthy equilibrium.

Implementation Risk: Manager Considerations

One of the foundational decisions a family must make is whether to invest passively, with active managers, or to take a combined approach. If a family chooses to invest with active managers, they should be confident in their manager due diligence process and comfortable with the risks of active management.

In the due diligence phase, investors will need to assess a manager's investment strategy, team, portfolio, and risk management abilities, as well as their overall organization and potential operational risks. There is no such thing as an investment with zero inherent risk. However, sufficient resources must be devoted to performing thorough diligence on each potential investment manager to reduce risk wherever possible. Once an investment is made, managers must then be actively monitored to confirm organizational stability, investment processes, the current investment opportunity set, and operational soundness.

In building a diversified portfolio, the goal is not only to find managers that can outperform over the long term, but also to create a portfolio that is greater than the sum of its parts. To ensure managers in the portfolio complement each other sufficiently, they must be looked at together. Additionally, reviewing managers' current holdings will highlight overlapping exposures that can lead to redundancy. These analyses should be undertaken regularly to confirm that historical behaviors and current manager positioning are in line with expectations and match the overall risk/return tolerance of the investor.

To ensure that high-conviction managers are sized appropriately, frequent analysis of the portfolio's level of "active risk" is necessary. Active risk is the product of an investment's capital allocation and the tracking error of that investment relative to its benchmark. Higher levels of active risk mean a manager is more likely to impact portfolio performance relative to the benchmark—either positively or negatively. The right level of active risk—per individual manager and total portfolio—will vary by investor. The important thing is to understand why individual managers are sized the way they are and to regularly monitor a portfolio's active risk to ensure the sizing of individual positions remains aligned with conviction in the manager.

Portfolio Monitoring and Communication

The ongoing management of a portfolio requires the proper processes to support and execute trades, fund capital calls, manage stock distributions, and carry out regulatory requirements. Having sufficient operational support—either within the family office or through outsourced partners—is key to effective investment execution.

Once a family has established their risk management framework and investment execution strategy, the next step is to establish a systematic process for monitoring the portfolio. This should not be a "check the box" exercise, but rather should be focused on analysis that can actively inform decisions for the portfolio.

Furthermore, proper management of strategic risk, implementation risk, and portfolio monitoring only goes so far if it happens in a vacuum. Regularly communicating the outcomes of a well-executed risk management framework keeps stakeholders informed, helps to reduce behavioral risks, and ultimately increases trust.

Understanding and Managing Risk

We believe the most effective investors are those that have a clear understanding of risk. What's more, they understand that effective risk management is not a checklist of one-off measures, but an ongoing, highly disciplined process. Family investors should be clear-eyed about the resources needed to strategize, implement, monitor, and communicate about a portfolio for it to meet its goals over time. Working with an investment manager that can provide timely analysis and routine portfolio health checks should help families feel confident that their portfolio is well structured—and positioned to succeed.