

Market Risk Review: An Introduction

I have been involved with the management of institutional money for over 15 years. First as a corporate banker, then as an investment analyst who matured into a Treasurer, and finally as a CIO at an Asset Management Company. Throughout this period, the one constant that I can attest to is that the people who manage the money managers choose not to acknowledge the risk-return tradeoff. The expectation is that the investment portfolio will deliver the highest returns possible, without taking on any incremental ounce of risk.

However, as an old friend used to say, the fault, dear Brutus, lies not in our stars but in us; let me explain: The combination of a highly regulated market and consistently large budget deficits for the better part of the history of our financial markets meant that the bulk of asset deployment was marked for risk-free assets, thus risk management was never given a very high priority. The major risk that our predecessors had to deal with was credit risk, and since the bulk of market assets were either government securities, or backed by the government, there was little risk to manage.

The subsequent de-regulation and privatization of the 90s led to increasing sophistication of financial markets, however, risk management did not keep pace, and has been until recently considered more of an art than the science that it is. This has been our failure as money managers. Because we have not been good at stating risk in objective terms "X units of risk vs. Y units of return", i.e. the risk-return tradeoff.

The Market Risk Review will enable us to do just that, by objectively evaluating risk characteristics, and looking at risk in quantifiable terms, including the following:

1. Value at Risk
2. Put Premiums
3. Sharpe Ratio
4. Treynor Ratio
5. Jensen's Alpha

By arming ourselves with the appropriate tools, we will be better able to manage portfolio performance, as well as to establish realistic expectations for investment performance within a given economic environment.

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