Viewpoints

Making Risky Portfolios Healthier

Will Rainey

Will Rainey, Head of Investment Strategy for Asia, talks about what **Investment Strategy team** does at Willis Towers Watson and also how the team and client advisors work with Asian clients to diagnose various areas that require improvement.

Tell us about your background and your role at Willis Towers Watson?

WILL: I started my career as a traditional actuary, calculating liabilities for UK defined benefit pension schemes. After three years and completing my actuarial exams, I moved to legacy Towers Watson to join their investment strategy team in London. The role allowed me to apply my understanding of client liabilities to help them consider the appropriate investment strategy which would allow them to meet their long-term objectives. Before I left to come to the Asia, I was the strategic advisor to a number of the largest institutional investors in the UK.

In September 2014, I moved from London to Hong Kong to head a new investment strategy team for Asia. We are now working with a wide range of clients including retirement funds, insurance companies and endowments across Asia.

How does your work fit in with the Willis Towers Watson's investment process?

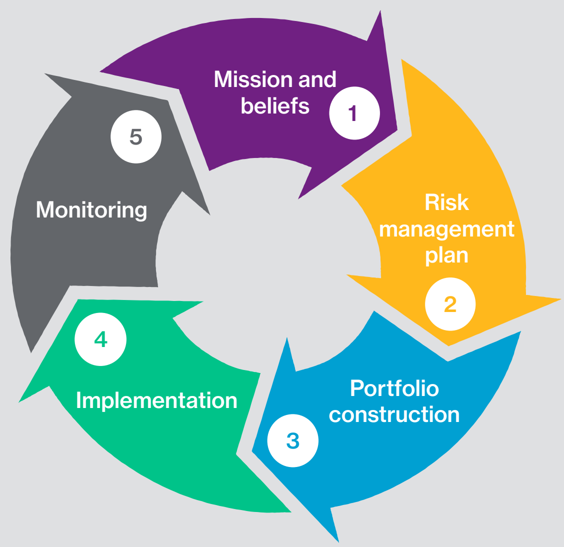
WILL: Whilst investment strategy covers most parts of the investment process (*Figure 1*), the main areas are the 'Risk management plan' (Step 2) and some elements of the 'Portfolio construction' (Step 3).

As part of the 'Risk management plan' we first consider how we convert a client's mission into measurable investment objectives, whether this is to achieve a certainty level of return whilst minimising risk or maximising returns subject to an explicit risk limit. Without these clear and measurable investment objectives, it is impossible to tell if an investment strategy is successful or not. The risk management plan is therefore about understanding what level of risk, relative to the objectives, can be taken and what to do if the investment strategy is not expected to achieve the objectives in the future.

We assess not only the level of risk to be taken, but also which risks matter in setting out an investment strategy. Our analysis involves identification and comparison of all the different risk exposures the client is facing. Then we set an investment strategy which looks to mitigate unrewarded risks (duration risk in the liabilities or currency risk) as well as get the right balance for the risks, which are expected to generate the returns to meet the objectives. Examples of such risks include equity risk, credit risk, illiquidity risk, insurance risk and skill.

An outcome of the above is an investment strategy which can be implemented in a simple, low cost manner. It would also form a benchmark which can be refined using different portfolio construction ideas such as smart beta, active management, illiquid investments and diversified funds (considered as Step 3 in the investment process).

Figure 1. **Willis Towers Watson's investment process**



How does the Investment Strategy team help clients assess risk?

WILL: The Investment Strategy team considers what risks are being taken and their consequences. This is best explained in an example:

Suppose there are two different investors both with a 50% equity and 50% bond portfolio. In this example the asset risk exposure for both is similar. However, the first investor is responsible for a new defined contribution scheme where the membership is young and the second investor is responsible for a mature defined benefit pension scheme. If there was a risk event, the first investor would not be materially impacted as they have a long time horizon and would be able to use new contributions to purchase assets at relatively 'depressed' prices which is good for the long-term.

On the other hand, the mature defined pension scheme is paying out large amounts of assets in benefit payments. As a result, any fall in markets would be crystallised (have to sell at 'depressed' prices) and could result in more money being required from the sponsor to recover those losses. Therefore the impact of the risks taken are materially different for the two different investors despite the asset risk exposures being the same.

Once a client understands what risks they are exposed to and the potential implications, we can then consider how to manage these risk to increase their investment efficiency (return per unit of risk taken). We believe we can improve the amount of investment efficiency by around 20% to 50% compared to a simple equity and bond portfolio.

How does portfolio construction work differ from and link with what you do, for example, in terms of advice or deliverables?

WILL: The key difference is the time horizon and level of granularity. Our focus is more on the long-term asset allocation and ensuring the appropriate risk exposures are clearly understood and managed. Portfolio construction then considers how and when these allocations are implemented.

For example, an outcome from the investment strategy review might be to allocate 25% of total assets to global equities over the long term. The portfolio construction piece would then consider whether this should be implemented passively, actively or using smart beta. It would also consider whether it should have any regional biases, how liquid this allocation should be, and if there should be any medium-term overweight or underweight positions relative to the long-term allocation based on current pricing of equities.

Can you tell us a bit about what you have been working on recently?

WILL: We have been carrying out a number of 'portfolio health checks'. As shown in *(Figure 2)*, these are reports which provide a high level, holistic overview of a client's portfolio and processes and comparing these to what we see as 'best practice'. This allows us to help our clients prioritise areas which will make the most amount of difference to future outcomes.

One of the key challenges our clients face is knowing what areas to focus on. There are many different investment products out there and many people providing views on different topics, making it hard to decide what to do next. The portfolio health check helps with the filtering process and gives a clear overview of the different areas which require consideration for efficient and effective management of an investment strategy.

For example, a client was concerned about the performance of a particular manager and was going to spend an entire meeting considering whether or not to retain that manager. Our health check report highlighted that the manager's performance (whether good or bad) was going to make little impact on the performance of the portfolio as a whole. Given that the impact from equities underperforming would make over 15 times the difference on the portfolio compared to the impact if the manager underperformed, the client's focus should instead be on how they were going to manage the equity risk they were taking. ■

Portfolio health check . . . gives a clear overview of the different areas which require consideration for efficient and effective management of an investment strategy.

To learn more about portfolio health check, read ***Take good care of your 'portfolio health', says Willis Towers Watson*** as published in AsianInvestor.net:
http://www.asianinvestor.net/News/429853,take-good-care-of-your-8216portfolio-health8217-says-willis-towers-watson.aspx

Figure 2. **Willis Towers Watson's Portfolio Health Check Report - Sample Output**

3. Analysis of different risk exposures

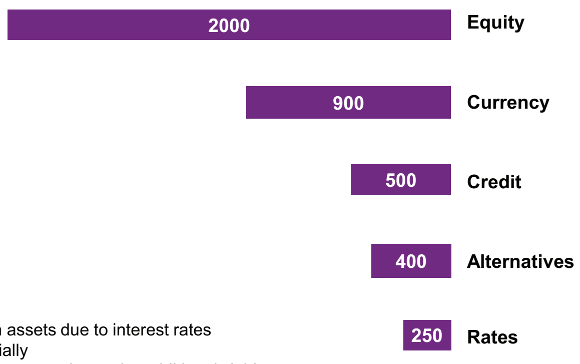
Best practice

- Compare risks directly
- At least partially hedge poorly rewarded risks (e.g. currency)
- Agree the appropriate credit/equity/diversifying strategies split

SAMPLE

Health check

1-in-20 chance of assets ($) falling by at least …



Definitions
Rates: The fall in assets due to interest rates increasing materially
Credit: The fall in assets due to the additional yield from corporate bonds increasing materially.

Diagnosis

Whilst half of the assets are invested in equity assets, the equity risk dominates the risk profile of the Fund.

High level of equity risk

We would recommend that ABC Institution considers alternative sources of return to reduce the reliance on equities, especially given the strong performance of equities over the last 6 years. Alternatively, equity options could be used to manage the level of equity risk.

Currency risk

The Fund is quite exposed to currency risk which we believe is an unrewarded risk. We would recommend that the currency exposure is reviewed to ensure the Fund is not taking unnecessary risks.

4c. Portfolio construction: Active management

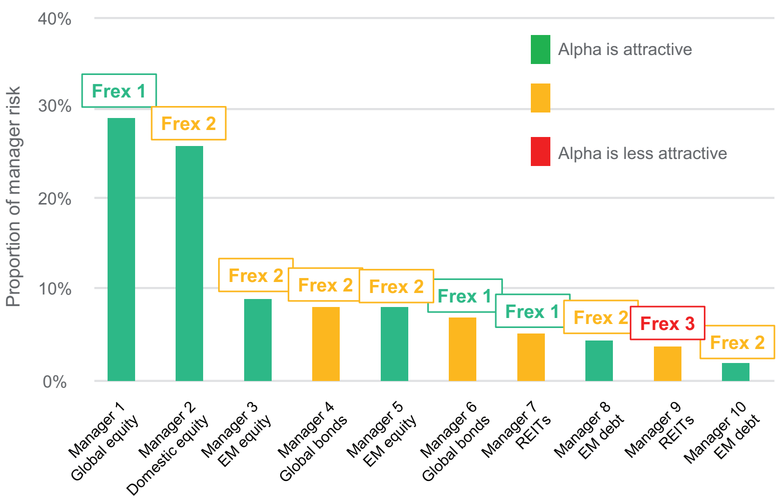
Best practice

- Active management risk aligned with manager conviction and impact on the portfolio as a whole
- Active management taken in markets with greatest opportunity

SAMPLE

Health check

Split of active manager risk (top 10 manager exposures shown)



Diagnosis

Manager 1 and Manager 2 dominate the active risk budget, that is to say that their performance will make a substantially bigger impact on the overall portfolio compared to the other managers held.

Reduce largest exposures

The Fund should consider reducing their exposure to Manager 1 (Global equity) and Manager 2 (Domestic equity). Also, the Fund should consider the benefits of retaining the managers which are not expected to have a meaningful impact on the portfolio as a whole and replace these with lower cost passive or smart beta managers (where appropriate)

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