Why investors need to revisit risk management

Central Banks' interventions have distorted market prices and dynamics. This has rather significantly changed the portfolio risk management.

Portfolio risk management prior to successive QEs

A balanced portfolio between fixed-income and equities offered a satisfying risk-adjusted performance provided the selection of equities and bonds were adequate. Equities would generate long-term performance, bonds would dampen their subsequent volatility providing some stable returns, while a smart diversification would bring further positive contribution. This no longer works. Central banks' interventions have lowered bond yields to such levels that they no longer generate protective returns and can actually add to fund's volatility. Furthermore, liquidity-driven markets have made the correlation between asset classes rise dramatically. They now move in unison upwards or downwards. So how to manage portfolio risks efficiently in such an environment?

Efficient risk management in the current environment

There is no magic solution to this problem just some clear rules.

First, if correlations are high, consider thinking in gross-exposure terms, rather than in net. In other words, to reduce efficiently the risk, raise cash by selling what you like the least rather than by playing some sophisticated hedging strategies which could backfire through unexpected correlations. Secondly, swear allegiance to your strong convictions, as focusing on high conviction bets and a healthy level of cash position represents a "barbell strategy",- probably one of the most suitable approaches to risk management in the current environment. If your high convictions are proved correct, they will generate enough returns to pull the performance of your fund, otherwise, your cash position will limit the damage and reduce the volatility. In technical terms, this approach brings convex optionality to your portfolio creating a favorable risk asymmetry. Also widen your investment universe and be open to rare but available opportunities. For instance, emerging markets have not undergone quantitative easing. Therefore yield curves are still "normal". This makes it possible to find bonds with attractive risk-adjusted profiles more easily than anywhere else. Also, as passive funds have become a dominant force in market flows, periods of corrections tend to be more violent.

Markets do over-shoot more frequently. Your cash position will allow you to treat such periods as opportunities to buy quality-assets at deflated prices.

In conclusion, markets have become riskier, but can still be steered provided the approach to portfolio risk management is adjusted.