

## RISK MANAGEMENT FOR MERE MORTALS

*By John Por and Tom Iannucci  
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*Risk management is not just for megafunds. Here are four principles for plan sponsors to bear in mind.*

For most pension organizations, the nature of risk management is, of necessity, very different than it is for the nation's few megafunds. The typical fund has limited resources, and developing costly risk management programs is not feasible. Moreover, while megafunds may take the form of separate divisions with a relatively high degree of autonomy that allows them to establish streamlined decision-making processes, most funds must deal with cumbersome structures involving a board and several committees. In the case of public funds, these structures are more difficult still, as external advisory committees, government bodies, and regular board turnover may all come into play. Effective risk management under such circumstances is extremely difficult. Finally, most funds are simply unable to justify having a staff dedicated to risk management--many, in fact, do not have staff dedicated to the basic investment functions.

Faced with these realities, how is a typical fund to cope? The situation is not as bleak as it may seem. Funds can implement risk management programs that are as effective as those of much larger funds, though of course not as elaborate. Here are four principles that fiduciaries may wish to bear in mind:

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- **There exists a hierarchy of risks.** Risks are not homogeneous. Instead, they vary in terms of their magnitude and likelihood of occurring, and resources should be channeled accordingly.
- **Different fiduciary levels must focus on different tiers within the risk hierarchy.** Senior fiduciaries--boards and senior executives--must set risk parameters in the most significant areas: asset/liability mismatch, maverick risk, asset class risk, etc. This allows operating fiduciaries to then focus on lower-level risks associated with managers and portfolios.
- **Relevance before accuracy.** When deciding which risks to measure and manage, fiduciaries must remember that accuracy does not come without considerable effort. Direct costs include the resources and staff time needed to generate the data. More importantly, there are indirect costs in that ever-increasing amounts of data may in fact create more noise than decision-makers can readily handle, and thus reduce the quality of decisions. In risk management, what really counts is identifying the true issues and ensuring that the effort expended is relevant to those issues. With relentless focus and by maintaining the investment program within one's means, funds may not require as much data as they initially thought.

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- **Not all risks must be assumed.** This is important for funds with limited resources, for it may be better to forgo potential rewards than to pursue opportunities without the concomitant ability to manage the associated risks.

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