Events show risk management is “inextricable” from alpha generation, says Man Group CIO Sandy Rattray

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Hedge funds and asset managers must design portfolios to successfully weather volatile markets, and "invest heavily" in technology, rather than focus on predicting the next downturn, says Man Group chief investment officer Sandy Rattray.

Rattray – who has co-authored a new book on strategic risk management along with Man Group strategy advisor Professor Campbell Harvey, and Otto Van Hemert, director of core strategies at quant-focused Man AHL – believes the upheaval of the past 12 months have rendered tail event predictions "nearly impossible."

Their new book, titled Strategic Risk Management: Designing Portfolios and Managing Risk, explores how risk management should be incorporated into the core design of investment portfolios, and examines how portfolio balancing and balanced return streams can be achieved through volatility targeting of higher-risk asset classes, and which defensive strategies offer capital protection.

In the book, Harvey, Rattray and Van Hemert argue that risk management is "inextricable" from alpha generation.

"We should not be focused on predicting the next downturn but on designing our portfolios to be as resilient as possible through volatile markets," Rattray said. "One of my core beliefs is that risk management is an equal partner to alpha generation, and asset managers should invest heavily in technology that empowers their risk management capabilities."

While some active fund managers see the risk management function as a series of "tripwires" which are typically only activated after a portfolio is in trouble, the authors believe it is detrimental to treat risk management as an afterthought.

The book probes the performance of various investment strategies during stressful market conditions, and highlights those that tend to mitigate portfolio drawdowns during adverse market events – such as futures trend-following and quality long-short stock strategies, as well as volatility targeting. It also examines how traditional 60/40 equity/bond portfolios increase drawdowns and heighten risk, and instead calls for strategic rebalancing more closely attuned to market conditions.

CIO Rattray is a co-inventor of the VIX index, who before joining London-listed alternative investment giant Man Group in 2007 spent 15 years at Goldman Sachs where he was a managing director in charge of its Fundamental Strategy Group. An MSCI Advisory Council member, he also earlier ran equity derivatives research at Goldman in London and New York.

He said he hoped the text, which will be published in July, would provide a helpful framework to understand and implement strategic risk management techniques. Its findings are based on five years of research and several decades of market data and quantitative portfolio management expertise.

Although the research was conducted prior to the Covid-19 pandemic, the March 2020 market sell-off offers "a unique out of sample experiment" that provides evidence supportive of the book's approach.

"To date, the asset management field has largely overlooked the crucial role of risk management, often establishing it as a secondary, support function for investment teams," added Professor Harvey. "Our research provides an encompassing approach to managing risk in good, bad and ugly markets. We hope to change thinking..."
Harvey, a professor of finance at Duke University and research associate at the National Bureau of Economic Research in Cambridge, Massachusetts, has been an investment strategy advisor to Man Group since 2005 and has contributed to both research and product design.

Otto Van Hemert is a member of Man AHI's management and investment committees, and was previously head of macro research at Man AHL. Before joining the unit in 2015, he ran a systematic global macro fund at IMC for more than three years and, earlier, headed fixed income arbitrage, credit, and volatility strategies at AQR.

All proceeds from the book will be donated to The Access Project, a non-profit organisation which supports students from disadvantaged backgrounds to access top universities through tuition and in-school mentoring.

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