

Global Currents

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Key Lesson from 1994: Don't Underestimate the Value of Risk Control

Aggressive investors who sought higher returns in 1994 experienced keenly the measure of their risk control. Of course, investors aiming for higher returns recognize that they must bear a higher degree of risk. But just as the level of risk influences the rewards investors reap in good times, the quality of risk control mitigates or exacerbates the distress they suffer in bad times.

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A disappointing year with unexpected shocks

Most investors found 1994 to be a difficult year. Interest rates increased in virtually every major market—a practically unprecedented occurrence—so bonds performed poorly for almost all investors. **A** In the us market, the Lehman Brothers Aggregate Index returned 11.28% per year from 1989-93; in 1994 it returned -2.92%. (See page 2) Equity markets offered no relief. **B** The us Equity Market Index returned 14.52%, annualized, for the five years ending December 31, 1993; for 1994 its return was -0.12%. (See page 2) Many other countries showed similar results; few aside from Japan performed well. For us investors, only unhedged international assets performed well, as Americans who invested abroad enjoyed the benefits of a substantial slide in the value of the us dollar, particularly against the yen.

Consequently, 1994 can best be described as an unusually bad year, but it was not a disaster. On average, investors probably posted small losses during 1994. Yet, while most investors finished the year disappointed, the overall results did not explain the type of investment catastrophes that befell some major hedge funds, large investment houses and mutual funds as well as

a large lender of securities and the treasurer of a wealthy California county. One might ask how these investors could lose so much, while others took their lumps but lived to invest another day. The answer comes down to risk control.

As us bond yields fell dramatically during 1992 and 1993, many institutional investors concluded that expected returns for all assets were falling as well. To make up for this decline, some of them redesigned their portfolios, increasing expected returns and risks. Looking back on these decisions, it's clear that risk control was the main factor in determining how these strategies performed during last year's difficult markets.

Perception versus reality

Many of the investment strategies that failed during 1994 did so because they were, in fact, more aggressive than they seemed. Some made use of hidden leverage. Others hedged ordinary risks, but the strategies remained sensitive to the exceptional market events of the year. Still others depended on trading strategies that could have worked, except that liquidity disappeared at crucial moments. Some suffered combinations of all three. They were like experienced hikers in the wilderness who discover a shortcut that leads to a high ravine on a narrow, rickety bridge. Recognizing that the bridge is high, narrow and rickety, they equip themselves with ropes, harnesses and belays—all the safeguards they apparently need. But they find out too late that the real peril is the hungry mountain lion at the other end of the bridge.