

Risk Gone Wrong: A Better Approach to Risk Measurement

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Following consecutive bear markets, investors have become acutely aware of the risks within their investment portfolios. In the past decade, the financial markets have produced subpar returns while exhibiting above-average risk. Yet risk is a rather vague term, encapsulating some less-than-obvious concerns that must be understood and evaluated.

In the financial industry, risk is most often defined as the uncertainty or volatility of returns. Volatility occurs in both directions. Upside volatility, better recognized as a positive surprise, is not what many would consider a risk. Rather, it is downside volatility that really matters: How likely are we to lose money, and how much do we stand to lose?

At Glenmede, we account for all the ways an investment could miss expectations, and then hedge or protect portfolios accordingly. In addition to volatility risk, another form of risk we consider and monitor is *liquidity risk*, or the inability to convert an investment into cash in a timely manner. Some investments commonly described as “lower risk,” due to the stability of the returns, may increase a portfolio’s liquidity risk.

Liquidity risk is not always discernible, as demonstrated by the auction-rate securities market in 2008. Many investors who had relied on these securities as a higher-yielding deposit for near-term cash found that the markets had unexpectedly closed overnight,

essentially halting all movement, including the ability to withdraw funds. In many cases, market participants who required immediate access to their funds were forced to find more costly sources of near-term cash. Up until the point when the markets closed, auction-rate securities had been considered, by sophisticated investors and public corporations, a reliable alternative to other short-term instruments.

Nontraditional fixed-income instruments, for example, are often used to “cushion” portfolios, but some can be quite difficult to trade when the financial markets suffer from dislocations such as those recently observed. Even Treasury Inflation-Protected Securities (TIPS) can experience this restriction, although much less than other more obscure instruments. TIPS offer investors many unique benefits and can be good investments, but liquidity is limited relative to more traditional Treasury securities and can result in higher trading costs.

We believe it is important to utilize a framework that evaluates both the downside risk and the liquidity risk.

The chart on page 2 outlines a basis for understanding where each asset class generally falls on the risk continuum.

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A Message from the President

Gordon B. Fowler, Jr., President and Chief Investment Officer



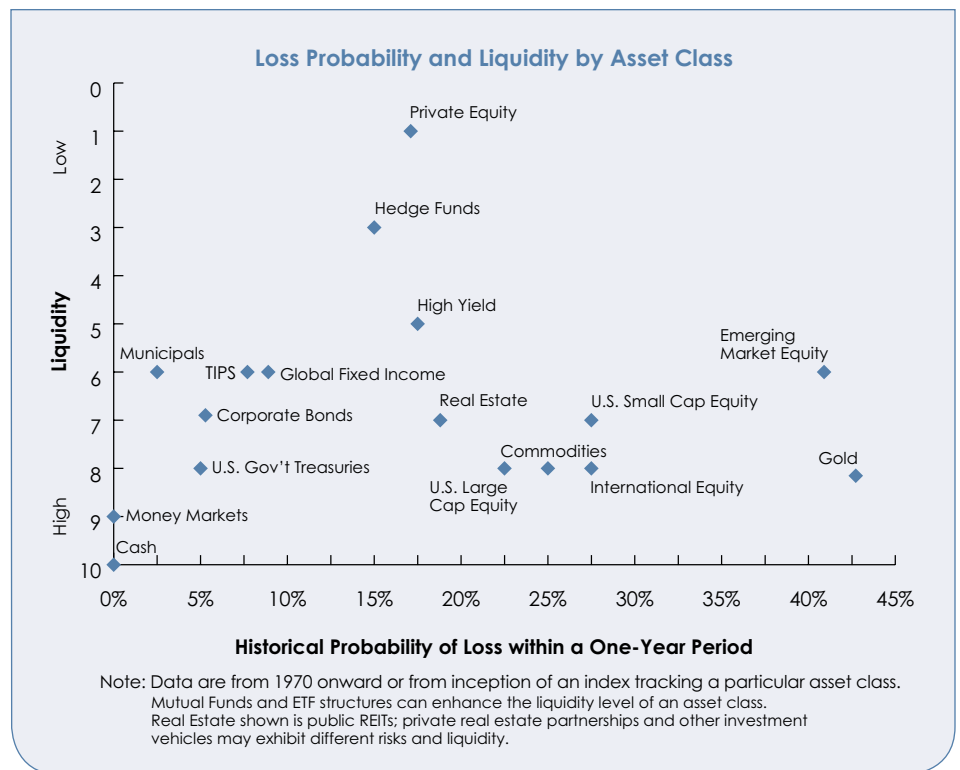
The financial industry has provided an abundance of source material for an extended summer reading list. *The Big Short*, *Fool's Gold* and *Too Big to Fail* entertainingly convert an arcane subject, the subprime mortgage meltdown, into a highly readable series of unfortunate events. For those who believe investors are best served by financial institutions that are transparent, focused, and without conflicts of interest, these books offer an appeal for regulatory reform that addresses the abandonment of fiduciary standards and practices.

Perhaps the next book to be written will be entitled *Too Complex to Regulate*. Still, regardless of how Congress ultimately enacts the numerous proposals now being considered, Glenmede remains transparent in its actions and focused on behalf of our clients' best interests.

We wish everyone an enjoyable and relaxing summer.

- **Cash and money market investments**—The most liquid and with limited downside.
- **Traditional U.S. government bonds**—Excellent liquidity and downside protection, but not as good as cash.
- **Municipal bonds and TIPS**—Favorable downside protection, but not nearly as liquid as U.S. Treasuries.
- **Large-cap U.S. equities**—Excellent liquidity, but the potential for loss is much greater than with traditional bonds.
- **Hedge funds**—A unique investment opportunity, typically with low-to-moderate volatility offset by liquidity-limiting lockup periods.
- **Private equity**—Both volatility and liquidity risk in the same vehicle, but offers the potential for far higher returns.

It is important for investors to view risk as multifaceted and to understand exactly what protection



may be relinquished by investing in one asset class as opposed to another. Often, an appropriate balance of strategies with different risk/return characteristics produces the best results. Glenmede carefully weighs the financial circumstances, goals,

and risk tolerance of each client in order to customize and tailor portfolios. This distinct approach to understanding risk provides the framework upon which we make allocation decisions.

Stability Exists in Many Forms

Benjamin Alimansky, Director of Manager Alliances Program



An interesting story emerged from the extreme volatility of the financial markets over the past few years as asset allocators searched for ways to dampen portfolio volatility. Hedge funds, typically portrayed as high-risk investments, proved to be more flexible and to provide greater stability than more traditional investments.

As stewards of capital, we continuously think about how to enhance portfolio performance and reduce risk. Hedge funds offer

investors a distinctive tool for achieving this goal by providing increased return stability in exchange for reduced liquidity. Hedge funds are highly flexible investment vehicles that rely on a variety of investment approaches to achieve outperformance in up markets and protection in down markets. Perhaps the one characteristic that most distinguishes hedge funds from traditional investments, allowing them to outperform, is a manager's ability to go short. As a result, hedge funds have the potential to

achieve gains independent of the direction of the market.

Some simple statistics* can help illustrate this point. Over the past five years, the Standard & Poor's 500 Index, a widely recognized indicator of the U.S. market, was up 2.6%. In comparison, the HFRI Equity Hedge Index, a metric that benchmarks hedge-fund performance, was up 5.8%. Even more interesting is that the S&P's historical volatility over that five-year period was 16.3%, compared with 9.7% for the HFRI index.

*Data supplied by Zephyr StyleAdvisor, as of April 30, 2010.

Other hedge-fund strategies tell a similar story, including event-driven strategies that focus on corporate initiatives such as mergers, spinoffs, rights offerings, and investments in distressed debt, and global macro strategies that invest in top-down “thematic” situations. In addition, the Sharpe ratio, a measure of performance relative to volatility, is higher for hedge-fund strategies than for traditional, long-only investment strategies.

Why is this important? Volatility has been high since the start of the 2008 credit crisis. Significant fluctuations in performance—both positive and negative—are becoming increasingly widespread and more challenging to sidestep. Hedge-fund returns can be less sensitive to market volatility than more traditional investments, and when added to a portfolio can mitigate downside risk without sacrificing return.

There are many reasons for the risk/return differences between hedge funds and traditional funds, including:

- 1) An ability to take both long and short positions
- 2) The skill and talent of the managers, especially on the short side
- 3) The flexibility of the strategy and the type of assets purchased

Fund Name	5-Year Return	Volatility	Sharpe Ratio	Beta to S&P
S&P 500	2.6%	16.3%	-0.01	1.00
HFRI Equity Hedge (Total) Index	5.8%	9.7%	0.31	0.49
HFRI Event-Driven (Total) Index	6.7%	7.6%	0.52	0.37
HFRI Macro (Total) Index	7.3%	5.0%	0.91	0.04

Along with our colleagues who invest on behalf of the Pew Trusts, Glenmede’s dedicated manager research team has more than a decade of experience investing in hedge funds and more than 30 years of investment experience. In addition to our ability to source investments and conduct a comprehensive due diligence process, we have developed an extensive network of global relationships. These connections both generate investment ideas and enable us to further investigate the individuals making the investment decisions.

We invest in hedge-fund strategies that are fundamentally driven and in which success is not predicated strictly on the use of leverage, but rather on the manager’s ability to consistently render informed investment decisions. We identify hedge funds based on two key criteria: the quality of the manager and the correlation benefit that the investment brings to the portfolio. In addition, we seek strategies that are easily understandable

and transparent, meaning we have access to the key investment decision-makers and can discuss the portfolio constituencies. We also look for a strong alignment of interests between the general partner (hedge-fund managers) and the limited partners (investors), and the ability of the hedge-fund manager to run the business in an efficient and reliable manner. Lastly, we invest largely in geographically diverse long/short equity and event-driven strategies, while being sensitive to fees and liquidity.

Hedge funds, when strategically and diligently utilized, and when short-term liquidity is not a factor, can enhance a portfolio by reducing downside risk and providing opportunities for outperformance. In the more sideways, volatile market we expect over the next several years, these strategies will likely become a more relevant and prudent option for many investors. Our team remains available to meet with those clients interested in further exploration of this important asset class.

Four broad categories of hedge-fund strategies span the hedge-fund universe:

- **Equity long/short** strategies hold positions, both long and short, generally in equities and equity derivatives (call or put options). These strategies can be quantitative or fundamental and range from being strictly market neutral (zero market beta) to long- or short-biased.
- **Event-driven** is broadly defined as investing in corporate events and typically includes mergers and acquisitions, bankruptcies, and restructurings, as well as spinoffs and recapitalizations. Managers typically hedge market exposure to isolate specific corporate events.
- **Global macro** differs from other strategies in that it tends to be driven by top-down, thematic views on markets versus “bottom-up” investments in companies. Global macro investors often apply fundamental and discretionary approaches or technical and quantitative methods to general ideas.
- **Relative value** looks for mispricings between securities that have some fundamental relationship and would normally be linked by price. This strategy exploits pricing inefficiencies by seeking unusual mispricings of financial instruments in which the gap between the actual and estimated values is wide.

Philanthropy and the Recession

Nina L. Cohen, Director of Philanthropic Advisory Services



Even in these recessionary times, philanthropy continues to play a significant role in fulfilling the unmet needs of our society. Charitable

giving—now and over the past decade—represents approximately 2% of GDP,* including some \$227.4 billion of individual giving and \$38.4 billion of foundation giving. While the amount of charitable giving among individuals has remained relatively consistent over the years, how donors approach their giving is evolving.

Philanthropic giving has become more than merely writing checks or attending events. Donors, in addition to providing capital, are committing time and nonfinancial resources to the societal issues about which they feel most strongly. In doing so, there is a desire to find new ways to strategically allocate funds while also maximizing the ability to produce lasting effects.

Tracy Gary and Melissa Kohner, authors of *Inspired Philanthropy*, suggest creating a personal mission statement that answers the questions: “What do I want to do with my giving and my time and why?” The responses will lay the groundwork for a road map leading to the organizations whose missions and strategies align with yours. If a family gives jointly, it is helpful to articulate a collective mission and vision.

It is at this point that Glenmede, which has been assisting clients in meeting their philanthropic goals for more than 50 years, can help to craft a mission statement. We work with clients to develop a budget,

define funding areas, and identify and evaluate nonprofit entities. In addition, we help design a plan that meets their giving needs and is tax-efficient, and we oversee all the administrative aspects of their charitable gifts.

With a clearly articulated mission statement and a financial plan in hand, the next step is to narrow the sphere of potential recipients. During this process, it is critical that donors see themselves as an investor and the organization as a potential investment. Just as we research business or personal investments, we should diligently research the nonprofits we support. Donors should dig deeply into an organization’s history, track record, finances, programs, staff qualifications, and board leadership and should closely examine an organization’s website and recent annual report. If feasible, we recommend scheduling a site visit and speaking to key staff, board members, and other donors. If an organization is uncooperative, it may be an early warning that this particular entity is not the best steward of the contribution.

Philanthropic giving differs from financial investing, however, in that it is generally better to concentrate strategic giving among a few organizations rather than to diversify. By focusing your contributions, you will be better able to monitor and evaluate the success of each program.

By investing for the long term, you will have the confidence that your contributions will be allocated in a manner consistent with your philanthropic vision.



Online Resources

There are many resources available to assist donors in identifying charitable organizations and evaluating their effectiveness. Here are just two:

- **GuideStar** provides useful information about several million nonprofits, including their charitable exemption status, information returns (Form 990), board members, highly compensated staff, and financial data (www.guidestar.org).
- **Charity Navigator** rates charities by evaluating two broad areas of financial health: organizational efficiency and organizational capacity (www.charitynavigator.org).

Additional Resources

- **Picture Your Legacy** card deck and iPhone app created by 21/64, a division of the Andrea and Charles Bronfman Philanthropies, provide a unique way for family members across generations to discuss their philanthropic identity and aspirations (www.2164.net).
- **Inspired Philanthropy** by Tracy Gary and Melissa Kohner provides a step-by-step guide to creating a giving plan.

*Giving USA Foundation, *Giving USA 2010: The Annual Report on Philanthropy for the Year 2009* (Indiana: Indiana University Press, 2009). Giving USA is a public outreach initiative of Giving USA Foundation. The foundation, established in 1985 by what is now the Giving Institute, endeavors to advance philanthropy through research and education.

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