Part 2: How Institutional Investors Navigate Uncertainty by Mastering Risk

In part one of a two-part series, we drilled down into several things to think about when it comes to risk, including properly identifying critical risks and understanding elements that influence risk tolerance. In this discussion, we will weigh in on potential solutions that are driven by risk considerations as well as the importance of managing behavioral risks in fiduciary decision-making.

Solutions Driven by Risk Considerations

Institutions must develop proactive strategies to mitigate risk. A well-structured risk framework includes clear policy definitions, periodic reassessments, and mechanisms to adapt to changing market conditions.

A strong investment policy should articulate a risk framework by defining risk parameters. Many committees focus on asset selection but fail to establish clear guidelines on acceptable risk exposure. As David Swensen writes in Unconventional Success, "A disciplined asset allocation strategy serves as an investor's best defense against market uncertainty."[1]

Scenario planning and stress testing help identify vulnerabilities. Institutions should run simulations that analyze the impact of different risk scenarios, including market downturns, liquidity crises, and inflationary pressures. Knowing the portfolio's potential value-at-risk (VAR) is crucial. The most important part of every plan is considering the possibility that the plan may not go as planned!

Institutions can conduct desktop exercises where committee members discuss potential crisis scenarios and their responses. This process reveals gaps in existing risk strategies and prepares committees for real-world financial disruptions.

Sample Illustration: Pension Fund Behavioral Bias

A pension fund's investment committee relied on past market trends to predict future returns, heavily anchoring their assumptions on historical performance. When interest rates rose unexpectedly, their fixed-income investments suffered, exposing the fund to liquidity issues. This highlights how anchoring bias can lead to poor decision-making by over-relying on outdated data rather than adapting to evolving economic conditions.

While risk assessment surveys provide insights into an institution's appetite for risk, they should be used alongside quantitative analysis and historical performance data. Trustees and investment committees should ensure that risk assessments remain objective, consistent, and adaptable. A well-designed risk assessment framework integrates both subjective perspectives and data-driven insights.

Investment committees should incorporate regular performance reviews and decision audits. The modern investment landscape presents committees with an overwhelming amount of options and data. The challenge is not just accessing information but filtering and interpreting it effectively. Governance frameworks should include ongoing education, external advisory input, and periodic evaluations of risk exposure versus policy guidelines. Doing so ensures that committee members continue to grow in their knowledge and expertise, which can elevate the quality of the decision-making.

1 *David Swensen, Unconventional Success (New York: Free Press, 2005).*

Managing Behavioral Risks in Fiduciary Decision-Making

One of the most overlooked aspects of risk management is the impact of human behavior on decision-making. Investment committees must be vigilant about the psychological tendencies that can derail strategic objectives.

Overconfidence in past decisions can lead to excessive risk-taking, while herd mentality can cause committees to follow trends rather than stick to a disciplined investment strategy.

Institutions that focus too much on short-term losses may abandon long-term strategies that would have yielded better results.

Concluding Thoughts

Institutional investors thrive when they balance risk with governance discipline and long-term strategy. Developing a deep understanding of risk tolerance allows institutions to navigate uncertainty while maintaining fiduciary responsibility requirements. Institutions must continuously refine their approach, recognizing that risk tolerance evolves with market conditions, institutional needs, and governance structures.

To build resilience, investment committees should integrate robust risk frameworks, behavioral awareness, and structured governance. As trustees and committees refine their approach, they should embrace structured risk management strategies to ensure the institution's long-term financial stability. Institutions must therefore prepare for uncertainty, ensuring that their investment strategy remains adaptable and forward-looking.

Sample Illustration: Healthcare Foundation Portfolio Stress Testing

A healthcare foundation managing a large investment portfolio conducted stress tests to simulate the effects of a major economic downturn. Their analysis revealed that their asset allocation was too aggressive for their liquidity needs. By adjusting their portfolio to include more defensive assets and increasing cash reserves, they were able to sustain operations smoothly during an actual market downturn. This shows the benefits of scenario planning and proactive risk assessment.

For questions about this report, please reach out to your relationship manager.

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