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Fiduciary Insights

SEMANTIC RISK: READING BETWEEN THE LINES IN YOUR PORTFOLIO

WHILE INVESTORS MAKE A SCIENCE OF THE STUDY OF RISK, THEY CONSISTENTLY CREATE NEW HAZARDS THROUGH THE SIMPLE ACT OF FRAMING THEIR DECISIONS USING TERMINOLOGY THAT IS OUTDATED, MISUNDERSTOOD OR MISLEADING. This common failing produces what could be called semantic risk. Semantic risk impacts performance as much as any other form of risk, sometimes more. Instead of words being tools to illuminate thinking, they become boxes in which to contain and thus limit it. Worse, they convey different ideas to different people, trigger rote but inappropriate responses, change behavior, undercut performance and, in some cases, move markets. This paper explores the idea of semantic risk and what leading investors gathered at a recent National Strategic Investment Dialogue forum think about it and how to cope with and counteract it.

The Meaning of "Risk"

What's in a word? Almost always, it's more than a single definition. Meaning, like beauty, often resides in the eye (or between the ears) of the beholder. But when a word influences behavior, sets a guideline, establishes expectations, it can contain much more...the power to impact a portfolio's performance or even, in more extreme cases, to move markets.

As a consequence, investors need to expand both their vocabularies and their perspectives to make room for a term that covers an important and often overlooked investment concept: semantic risk. Make no mistake about it, semantic risk impacts performance as much as any other form of risk, sometimes more—because it is fueled by the institutionalization of myths, misunderstandings, incomplete perspectives, old-think, and other phenomena that plague investors, lead to bad analysis, foster miscommunication and hinder performance.

Semantic risk is created when a term is used improperly or imprecisely, resulting in misunderstandings that foster investment behavior that is adverse or unintentional. It is a product of the gap that often exists between the collective understanding of a market or a group of investors as manifest in a common interpretation of a term and the underlying reality.

Where do we find it? Everywhere, and everyone is impacted by it. From terms like "hedge funds" to "leverage" to the word "risk" itself, common understandings create or signal misconceptions that often spell trouble for portfolios and their managers.

There are few illustrations of the term "semantic risk" that are more compelling than "risk" itself. How investors characterize risk both demonstrates what they think of it and, in important ways, influences how they and those around them deal with it.

For example, in the simplest sense, when most people think about "risk" they limit the definition to potential loss or to excess or unanticipated volatility. They focus on the downside. But, in fact, there are risks that present themselves in an environment of strong gains. In particular, there is the behavioral risk embodied in the common impulse, when an investment is performing well, to "double up," or to imprudently put more assets into an investment or a category in a way that undercuts diversity, increases exposure to a narrow set of risk drivers, reduces other upside opportunities, and otherwise undermines risk and asset allocation objectives.

This point illustrates how commonly used terms acquire commonly used definitions that produce common behaviors that result in problems. Instead of words being tools to illustrate thinking, they become boxes in which to contain and thus limit it. Shorthand may be fine for court stenographers but it shortchanges the intellectual processes that are critical for fully understanding concepts like risk— especially because by definition risk lurks where it is unseen or unanticipated.

Indeed, the core problem with many of the common definitions of risk is that they are too narrowly defined or one-dimensional. Testing the terms or seeking out new ones is therefore a helpful process because it forces investors to reconsider their thinking, prejudices and practices.

There are other dimensions of risk that are often overlooked because of the lazy use of the most common definition of risk. A prime example in this respect is liquidity risk. Often undiscussed and unmonitored, there are sophisticated funds in the investment world that have ignored their growing exposure in this regard, resulting in portfolios which are not sufficiently liquid to permit a successful response to the opportunities that may be present after a major disruption—say a three standard deviation event. Investors should determine their maximum tolerable illiquidity in this respect, perhaps 30 percent of assets, and plan accordingly...but if liquidity is not something that is typically addressed in risk assessments or it doesn't appear on the agenda when boards turn their attentions to risk, this won't (and doesn't) happen.

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Another example of risk that is frequently overlooked is the institutional risk that can accompany an investment policy characterized by greater volatility or greater tracking error (difference from peers or policy) than the governing body expects or can tolerate. While the investment stance itself may make sense over the long term, if the oversight body does not appreciate the possibility for extended deviation from peers and policy that the investment stance adopted implies, it can abandon an underperforming strategy at precisely the wrong time, enhancing rather than limiting risk through institutional breakdown.

Data on Semantic Risk

In a recent gathering of investment experts and practicioners convened by the National Strategic Investment Dialogue (NSID), a discussion of the phenomenon of semantic risk produced the conclusion of one investor that "we are afloat on a sea of ambiguity." Participants broadly agreed that language itself can have market consequences and that poor investment decisions often stem from terms that are misunderstood or interpreted inconsistently because their meanings are so imprecise.

Among members of this group, "the most overused, misunderstood popular term in investing today" was determined via polling to be "hedge fund," followed by "absolute return" and "leverage." Subsequent discussions also revealed that some terms were often so deliberately distorted that they became less meaningful, such as "alpha," given that much of what is sold as alpha really contains significant elements of beta, or market exposure.

The group noted that Modern Portfolio Theory (MPT) itself might have created some of the rigidities we see in portfolio analytics and portfolio management practices. MPT, based as it is on asset categories, has motivated many to focus excessively on sometimes ill-defined boxes and benchmarks, and has both constrained portfolio management and led to a compartmentalized and therefore partial appreciation of what are often common risk factors. One solution that was offered was to focus not on asset classes but on factor exposures, although even this is not without its semantic risk related challenges.

Compounding this risk was the fact that governance structures often put major decisions in the hands of boards and others who are even more trapped by narrow or inadequate definitions and the assumptions associated with them. New strategies, in particular, often involve terms—from "hedge fund" to "leverage" to "alpha" and "beta"—that are not fully understood. Somewhat disturbingly, for this and other reasons, of those present in the meeting, almost two-thirds felt that a minority of investment policy oversight bodies actually had the "know-how and experience to assess and monitor modern investment strategies."

The Fault-Lines Beneath the Term "Leverage"

Among the liveliest discussions at the NSID turned on the subject of leverage, an issue that remains a contentious one among members of the investment community at large. In fact, few terms illustrate so well the core notion behind semantic risk, which can be described as "when misunderstandings lead to misallocations."

The problem with the term leverage is that it often carries with it a bad connotation. Precisely what the bad connotation is differs from investor to investor, complicating the problem. Among managers attending the NSID session called "Reinventing the Portfolio: Toward a New Investment Paradigm," some saw the principal risk associated with leverage as a loss of control over their assets and the consequent potential for losses resulting from the seizure of assets. Others saw the problem in terms of the complexities associated with assessing and monitoring leverage and how it might impact an entire portfolio, while for others it simply boiled down to the potential of losing more eggs than you actually had in your basket.

Yet, upon even perfunctory examination, investors acknowledge that it also stood to reason that a fund that is underleveraged is actually not tapping its full investment potential and is therefore succumbing to a different type of risk. Like most other terms pertaining to investment options, stripping the term of the baggage that is often associated with it is essential if an analysis is to be done properly. Leverage that does not appreciably increase the liquidity risk of a fund, for example, can be an essential element not only of enhancing performance but, by enabling a fund to further diversify, of reducing the real risks of underperformance or loss. Consequently, this tool, which is viewed by many with skepticism or unease, may actually be one that mitigates other, often equally misunderstood, risk factors.

These last points were illustrated during the discussions at the NSID meeting on leverage, in which participants cited an industry-wide phenomenon that one characterized as "leverage phobia." Over sixty percent of those participating in the meeting agreed with the statement that their "committee has a problem with leverage, even if it can be shown that, if used properly, it can increase returns and not necessarily volatility." Participants did, however, note that sometimes the concerns regarding leverage were not due to a misunderstanding of the term on the part of boards but rather due to concerns on their part that their managers were not sufficiently well-versed or expert in the appropriate application of leverage techniques to their fund.

The Award for Least Meaningful Term Goes to: "Hedge Fund"

Eight out of ten of those who attended the NSID meeting agreed that "the term 'hedge fund' is too broad to be useful." While this view is also held widely throughout the investment community, the implications of the vagueness of the term are less frequently discussed.

While virtually all professional investors understand that today "hedge fund" refers more to a compensation structure for fund managers than it does to the use of a hedging strategy (many funds are long only and some hardly hedged at all), NSID participants and investors worldwide are still increasing their allocations to the asset class called "hedge funds" at a rapid pace. They presumably jump in to the category seeking controlled risk strategies and often find that what they have bought is purely directional. At the same time, many boards and investors shy away from some funds because they are called "hedge funds" even though they may behave precisely as do other "traditional" funds known for their sectoral, regional or strategic focus. Also, as a majority of our NSID participants expect a major hedge fund blow-up in the next several years, it is easy to imagine the market sentiment that will follow, involving massive withdrawals from funds that employ utterly different strategies and have vastly different risk profiles or components of alpha and beta.

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Conclusion: In Search of Semantic Virtue

The distinguished group of investment leaders who gathered for the most recent NSID discussion concluded that the issue of semantic risk was compounded somewhat by the fact that we were in a transitional era in investment, moving away from traditional asset allocation models and toward a world of new hedging strategies and investment vehicles created by the revolution in securitization and derivatives. Such a condition of constant, relatively rapid change produces confusion under the best of circumstances and renders old ideas and the labels we are most comfortable with obsolete. It was also widely agreed that in such circumstances embracing more precise language was a critical prerequisite to understanding and communicating new risks and opportunities. (This is a point that illustrates itself as "alternative" strategies and vehicles gradually become mainstream and the term "alternative" itself is constantly evolving.)

Such a search for precision and linguistic discipline carries with it another concept that is the flip side of this bedeviling form of risk: semantic virtue. What this means is the circumstance in which the evolution and use of a particular term actually produces a healthy tendency in markets or individual portfolios. For example, through the more insightful discussion of concepts like liquidity or volatility, through the recasting of portfolios not in terms of categories of assets but rather in terms of vital characteristics such as alpha or beta, investors are more likely to be able to recognize and manage risk or achieve performance objectives more effectively.

Words define intellectual processes. They are the factors in the mental equations we all employ when assessing a situation. Change the meaning through misunderstanding or common misuse and it changes the outcome of the equation. Employ a wrong term or leave one out and the equation is incomplete.

While such an observation may seem on some level elementary, even groups of the world's most sophisticated investors, such as those present at our NSID meetings, readily acknowledge that the problems associated with semantic risk are real and, in a world of new and changing terms and a swirling mass of complex concepts, growing. Just as going back to basics, such as understanding underlying goals or investment fundamentals, is a vital discipline, so too is exploring how we categorize and communicate when speaking of investment challenges or objectives. And to do that reveals that one thing that sets semantic risk apart from others that impact performance is that its causes and its cures lie as much in ourselves and our managers as they do in our portfolios.

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[Please visit www.nationalstrategicinvestmentdialogue.com to find out more about the NSID.]

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