Part 1: How Institutional Investors Navigate Uncertainty by Mastering Risk

Recognizing, understanding, and mitigating risk is critical for any institutional investor. It shapes investment policy, long-term financial health and governance effectiveness. Many investment policies reference risk in broad terms, but few address the array of risks individually and proactively. A lack of clarity on risk exposures, risk tolerance and governance can lead to mismanagement, resulting in either excessive caution or undue exposure to market volatility. In this, the first of a two-part series, we will delve further into several things to think about when it comes to risk, including properly identifying critical risks and understanding elements that influence risk tolerance.

First, some quick thoughts when it comes to risk…

The collapse of Lehman Brothers in 2008 served as a stark reminder of the importance of risk management. While excessive leverage and risky investments played a large part in its downfall, a failure of risk management processes and strong governance ensured it.[1] Many institutions fail to understand and reassess their own risk exposures in time to prevent unnecessary losses or capitalize on opportunities. As Peter L. Bernstein states in Against the Gods: “The essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control.”[2]

Risk is not inherently negative—it is a necessary component of long-term investment success. The key to effective institutional investing is striking a balance between risk and return while fostering a governance structure that encourages disciplined decision-making. With clear risk parameters, ongoing assessments, and an awareness of behavioral pitfalls, institutions can position themselves for long-term stability and growth.

Identifying Critical Risks

Many institutional investors form Investment committees that must assess multiple risk categories to make informed portfolio decisions. Understanding the nuances of risk allows institutions to craft a resilient investment strategy while safeguarding financial sustainability. As David Swensen emphasizes in Pioneering Portfolio Management, “Risk and return are inextricably linked, and effective risk management must be an integral part of institutional investing.”[3]

There are two broad categories of risk to consider. The first is organizational risk. These include things that can impact revenue, costs, and balance sheet stability of the enterprise and the ability to meet cash flow needs without incurring losses. These risks can also include cybersecurity threats, counterparty risks and systems failures. Organizational risk might also include the risk of falling behind competitors or losing the public trust. These risks can take the form of poorly informed trustees who don’t possess the right knowledge to make decisions during difficult markets. Organizational risks may also include legal or policy changes that affect financial and operational strategy.

The second broad category of risk to consider is the investment risk inherent in managing portfolios. These include things that can impact asset values like general market volatility, and economic downturns. The possibly of bond issuers defaulting on obligations or other credit related impacts. Fluctuations in interest rates affecting both investment instruments as well as spending policies. It also includes decision making mistakes such as a tendency to rely too heavily on past data or the willingness to endure temporary losses for long-term gains.

Both organizational risk and investment risk need to be a part of any review process and discussion.

1 *Anton R. Valukas, The Role of the Accounting Profession in Preventing Another Financial Crisis (United States Senate Hearing, 2011).*
2 *Peter L. Bernstein, Against the Gods: The Remarkable Story of Risk (New York: Wiley, 1996).*
3 *David Swensen, Pioneering Portfolio Management (New York: Free Press, 2000).*

Elements Influencing Risk Tolerance

A variety of external and internal factors shape an institution's risk tolerance. Understanding these influences can help committees make more rational, strategic decisions and reduce the likelihood of impulsive reactions to market conditions.

Effective committees should include a mix of expertise. A well-rounded committee that combines investment professionals, financial analysts, and experienced trustees can lead to a more thoughtful and measured approach to risk. As Russell J. Fuller notes in The Investment Committee Guide, "A diverse investment committee fosters deeper discussions, challenges assumptions, and avoids groupthink."[4] It is also important that the committee Chairperson create an environment where all committee members can participate and be heard which allows diverse opinions to emerge.

Behavioral biases can distort investment decisions. Trustees and committee members may be influenced by emotions, recency bias, or peer pressure, leading to suboptimal investment choices. Daniel Kahneman, in Thinking, Fast and Slow, explains: "The illusion of understanding is a potent force in investment decision-making, often leading to excessive confidence in risk assessments."[5]

Endowments and institutions should adopt long-term perspectives. The ability to withstand short-term fluctuations in pursuit of long-term stability is a cornerstone of sound investment governance. As Jay Yoder et al. state in Endowment Management, "Institutions that maintain discipline through downturns are more likely to achieve long-term success."[6]

Sample Illustration: University Endowment Fund Mismanagement

A university's endowment fund experienced a significant drop in revenue due to declining student enrollment and reduced government grants. Because the investment committee failed to account for these external financial pressures in their risk management strategy, they were forced to liquidate assets at a loss to cover operational costs. This underscores the importance of considering organizational risk in investment planning and maintaining proper liquidity.

Stay tuned for next part of this two-part series where we will touch on potential solutions that are driven by risk considerations as well as the importance of managing behavioral risks in fiduciary decision-making.

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

4 *Russell J. Fuller, The Investment Committee Guide (New York: Wiley, 2017).*
5 *Daniel Kahneman, Thinking, Fast and Slow (New York: Farrar, Straus and Giroux, 2011).*
6 *Jay Yoder et al., Endowment Management (New York: McGraw-Hill, 2019).*