SBA FLORIDA
STATE BOARD OF ADMINISTRATION
At A Glance

Managing Risk

What is Risk?

Risk is the potential for disappointment. Those who invest in financial instruments face a variety of risks, some tied to the performance of the instruments themselves, some tied to the strategy for selecting the instruments, and yet others tied to the transactional processes through which investments are made. Every form of risk ultimately bears upon one fundamental consideration: the investment objective. The investment objective is the goal or goals an investor seeks to meet in putting his capital at risk. A thoughtfully diversified portfolio will diversify risk across a range of investments that collectively have the highest probability of meeting the investment objective independent of the performance of the individual investments.

A clearly formulated investment objective is an essential first step in managing risk. It provides a basis for prioritizing those risks which should be avoided or minimized (i.e., those which carry the greatest potential for frustrating the attainment of the investment objective). Importantly, it helps identify the type and level of investment risk that must be accepted in order to meet the objective.

The term “investment risk” encompasses risk that directly arises in the pursuit of an investment return. Other types of risk deal with threats to the organizational and managerial infrastructure that supports a prudent investment process and effective delivery of services. These are the risks that an informed investor mitigates or avoids to the degree it can be done cost-effectively. While there are numerous ways to classify the components of inherent risk, the SBA uses the following classifications:

MARKET RISK

This is the risk that the SBA may experience a loss from unexpected price fluctuations due to overall market movements. Market risk is a characteristic of all financial instruments. Generally speaking, the price of a security fluctuates due to market exposure and security-specific risk factors, collectively driven by the forces of supply and demand. Like any commodity in a freely functioning marketplace, the price of a security is directly proportional to its demand relative to its supply. There are numerous circumstances which can cause the demand for a particular security to increase or decrease. The demand for a stock, for example, is influenced by revised earnings expectations. Demand can also depend on a number of other factors including changing economic conditions, geopolitical events, inclusion in a particular market index, availability of similar securities, perceptions regarding specific industries, or company-specific factors.

CREDIT RISK

This is the risk that an issuer of debt securities or a borrower may default on financial obligations. Credit risk is a characteristic of debt instruments. Changes in investor perceptions of the possibility of a default by the issuer cause a bond’s prices to fluctuate, a phenomenon known as credit risk. For example, a credit rating downgrade by agencies such as Standard & Poor’s and Moody’s will typically cause the market price of the issuer’s bonds to fall because of perceived increases in the possibility of a default. As with interest rate risk, this risk does not affect the bond’s interest payments (provided the issuer does not actually default), but increases the volatility of the market price, which is of consequence to holders who may have to sell.

INTEREST RATE RISK

This is the risk that an investment’s value will change due to a change in interest rates. Interest rate risk affects bondholders more than stockholders. Due to the inverse relationship between interest rates and price, fixed-rate debt instruments are subject to interest rate risk, meaning that their market prices will decrease in value when generally prevailing interest rates rise. This allows the SBA the ability to earn a higher interest rate on its money elsewhere, perhaps by purchasing a newly issued bond that already features the higher current interest rate.

PREPAYMENT RISK
Prepayment risk is a special form of interest rate risk. It applies to callable bonds which are debt instruments that include an option for the issuer to "call" in the bond and repay debt early. In practice, bonds are most often called when interest rates are falling, resulting in an adverse reinvestment situation for the SBA. Once a bond is called, issuers can reissue the bonds at a lower interest rate. Thus, the SBA may not actually experience the larger cash flows it expected and must reinvest at lower market interest rates.

INFLATION RISK
This is the risk that the return from investing may not offset the loss in purchasing power due to inflation, a reduction in the purchasing power of money. It can arise from an expansionary monetary policy, economic supply shock, or as a result of behavioral responses to general perceptions about future price growth. The SBA seeks financial gains in real terms; that is, to increase the inflation adjusted value of the FRS Pension Plan funds under management to keep up with liability growth. But because investment gains are commonly presented in nominal (e.g., not inflation adjusted) terms, the SBA will meet this goal only if the nominal investment gains exceed the rate of inflation.

Since inflation is a phenomenon affecting an economy's unit of exchange, inflation risk affects nearly every type of financial security. Equity instruments of certain companies are more resistant to this risk than those of others, depending on the pricing power of the company. Pricing power is the ability to charge a higher price without suffering a proportional reduction in sales volume. Real bonds (e.g., Treasury Inflation-Protected Securities) are an exception. They are not subject to inflation risk since their stated yield and face value at maturity are adjusted to compensate for the contemporaneous rate of inflation.

LIQUIDITY RISK
This is the risk of having limited access to funds, a failure to meet liquidity needs, or a loss resulting from a lack of market liquidity. The SBA may find that, under certain circumstances, there is no ready buyer for a security it wishes to sell. The term "liquidity risk" distinguishes a form of market risk which typically occurs when demand for a given security is weak, or the supply of a security is low.

CURRENCY RISK
This is the risk that an investment's value may change due to a change in exchange rates. In addition to other risks, the value in United States dollars of securities of foreign companies (denominated in foreign currencies) varies based on fluctuations in the value of the applicable foreign currency relative to the dollar. This so-called currency risk arises from differences in current or expected real growth, interest rates, inflation, and macro-policies between the countries.

SYSTEMIC RISK
This is the risk that material portions of the global financial system will collapse or cease to function adequately. Systemic risk is the possibility of potentially catastrophic financial system instability, typically caused or exacerbated by idiosyncratic events or conditions among financial intermediaries. It results from interlinkages and interdependencies in the financial system or securities markets, where the failure of a single entity or cluster of entities could cause a cascading failure, potentially bankrupting or bringing down the entire system or market. All investments bear systemic risk.

IDIOSYNCRATIC RISK
This is the risk specific to an individual security. It may be based on the company itself or the industry in which the company operates. Otherwise known as "specific" or "unsystematic" risk, this risk can be mitigated through proper portfolio diversification.

Why Take Risk

Why must some level of investment risk be tolerated? Because there can be no investment return without the acceptance of risk. As the Barron's Dictionary of Finance and Investment Terms puts it, "if you don't want the risk, don't expect the return" – or, colloquially, "no pain, no gain."

In well-functioning financial markets, investors are willing to accept higher risks only with a reasonable expectation of a higher return. Why? Because demand and supply of capital are what ultimately cause higher risk investments to yield higher returns over the long-term. This stands in contrast to low-risk investments which, because of a relatively ample capital supply, yield lower returns.

The challenge for the thoughtful investor is to carefully assess their own tolerance for disappointing results versus the applicable investment objective, weigh the likely distribution of outcomes from various investment options, and select the course that appropriately balances likely outcomes over the investment horizon.

A challenge for any investor is determining which portfolio is best suited to their needs. Commonly, portfolios which emphasize capital preservation are thought of as low risk, whereas those that emphasize capital growth are deemed higher risk. These characterizations are certainly accurate if risk is viewed narrowly in the context of return volatility, i.e. the amount of uncertainty or risk about the size of changes in a security's value. For those with a short planning horizon, return volatility is indeed a significant risk – as is the risk of illiquidity.

However, investors with a long planning horizon may rationally conclude just the opposite. A young person with a 30- year career ahead and possibly another 30 years of retired life would be ill-served to invest his or her retirement savings in a portfolio of so-called low-risk (i.e., low-volatility) securities.

Such a strategy would indeed avoid the psychological stress of seeing sharp declines in the market value of the portfolio from time to time. However, by the time the portfolio needed to be liquidated, the investor would likely find it supported a far lower standard of living than one with higher interim volatility. To such an investor, year-to-year variation in asset values is not the principal risk; rather, it is the failure to accumulate sufficient wealth over the long run.

How the SBA Manages Risk

The SBA has concluded that cash investments – those that have the least volatility and the greatest likelihood of capital preservation – are the riskiest types of assets for the FRS Pension Plan portfolio. This is because they are least likely to provide the long-term growth necessary to support the Plan's liabilities and cash flows. Conversely, they are among the most appropriate investments for Florida PRIME, given its emphasis on short-term liquidity and capital preservation.

A clear understanding of the purpose for which funds are being invested is essential to effective risk management because the fundamental risks investors must manage are those which impede attainment of their investment objective. The SBA adopts investment policies for each of its portfolios that encompass both an appropriate investment objective for the selected mandate and an investment strategy designed to best support that objective. Investment strategies, in essence the amount of risk to undertake, are typically contemplated over a significant amount of time by the SBA with careful oversight and input from the Fund's Investment Advisory Council, the Board of Trustees, and one of the internationally-recognized investment consulting firms under contract.

The SBA is diversified across six asset classes as well as within each asset class.