



From the Risk Manager's Desk – Risk is Not a Four-Letter Word

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Key Takeaways

- ▶ Risk is an essential component of the investment process that we must take on to accomplish our goal of delivering attractive long-term returns.
- ▶ We see inflation, interest rates, recession and leverage risks as the most prevalent macro themes for our investment teams to be aware of as we enter 2023.
- ▶ Rather than shy away from uncertainty, we have brought our array of quantitative tools and broad viewpoints forward to take advantage of these opportunities.

Risk Analysis Helps, Not Hinders, Investment Decisions

It is all too common in the financial industry for "risk" to be considered undesirable and something to be avoided. However, risk is an essential component of the investment process that we must take on to accomplish our goals of delivering attractive long-term returns for our clients and outperforming market benchmarks over a full market cycle.

We understand that each investment portfolio constantly faces a multitude of market risks. While it is impossible to consistently forecast the future, ClearBridge's Investment Risk Management team employs risk models and develops custom analysis of current macro trends to help our investment managers understand their portfolio exposures from multiple perspectives. We consider ourselves partners in the investment process; instead of recommending specific stocks or sector weightings, we bring a data-driven and diverse point of view about potential sources of risk to help our managers complement their fundamental analysis. Rather than police investment teams, we encourage our managers to take risks when they believe they have a variant perception through their fundamental analysis or from a long-term view that eclipses the market's short-term gyrations. Likewise, we provide an outside perspective to help managers avoid assuming undue risk in areas where they do not expect to have an edge, such as short-term factor bets, or where they are not being compensated for taking the risk.

Current Market Risks

While no two market environments are exactly alike, they often have common characteristics thanks to prevailing macro themes. However, the past few years have been complicated by a confluence of several major catalysts that we have not seen at their current levels over the past 40 years. While the list is long, and seemingly getting longer, we have focused on the most prevalent macro themes when meeting with our portfolio managers during our quarterly risk review process.

Inflation Risk

In the wake of COVID-19 shutdowns, and stimulative monetary and fiscal policy measures used to keep the economy afloat, U.S. consumers have experienced an inflationary shock driven by supply chain disruptions as well as elevated demand for goods and services. In fact, inflation readings in 2022 were the highest in a generation and have resulted in a multitude of direct and indirect impacts across the economy.

In order to analyze the risk of inflationary pressures on our portfolios, we first looked at past periods of rapidly rising inflation but could not identify any comparable historical periods with inflation increases along with a similar macro backdrop as we face today. Therefore, we concluded the current environment is likely the best proxy for the near-term future and calculated the correlation of holdings in our portfolios (as well as their respective benchmarks) to recent changes in inflation. Our portfolio managers have been able to incorporate this data at the individual stock, sector and overall portfolio level with their fundamental analysis of company-specific input costs and pricing power.

Interest Rate Risk

Interest rates have been on a downward trend since the early 1980s, which means an entire generation of analysts and portfolio managers have honed their analysis and strategies against a backdrop of declining bond yields. As a result, with rates moving higher at a rapid pace since the second half of 2020, previously accepted assumptions are being turned upside down with far-reaching impacts across the ways companies' fundamental, corporate finance and equity valuations are calculated.

Over the past few years, we have conducted a variety of analyses to understand our portfolios' exposure to rising interest rates. One approach was to conduct historical studies of periods where rates rose by one percentage point or more within a short period of time and analyze the performance of our current portfolio holdings during those periods. Additionally, we evaluated the correlation of each portfolios' holdings to recent changes of 10-year rates under the hypothesis that the recent past is likely the best proxy for the near-term future. With both approaches, we used our quantitative analysis to discuss with our portfolio managers the likely impact of higher (or stable) interest rates on their holdings, sector exposures and broader portfolio.

Recession Risk

The risk of recession is probably the most discussed current topic in the media and investment circles, with a wide range of opinions on what would be the severity and duration of a recession.

We've reviewed historical recessions and have found that each period is largely the result of its individual macroeconomic environment and unique catalysts that initiated it, such as the oil shock of the 1970s, the Global Financial Crisis in 2008 and the COVID-19 pandemic in 2020. As bottom-up fundamental investment managers, we don't venture to guess the likelihood, length or depth of a recession. Rather, we focus on utilizing our broad perspective to offer managers a more qualitative approach surrounding the discussions of industry exposures to defensive and cyclical themes.

Leverage Risk

The rising cost of capital and refinancing, and potential bubble-like conditions we are seeing in some areas of the market, has increased the need to evaluate investments for financial distress. The low interest-rate environment of the past decade helped to increase the valuation of longer-duration, high-growth stocks, including many early-stage companies that have yet to generate any profit. Many of these companies' management teams used this era of cheap capital to issue significant debt to finance their rapid-growth visions. However, the trifecta of higher rates, persistent inflation and an economic slowdown have left many of these high-growth dreams shattered as it becomes more expensive to finance business operations.

We use a variety of approaches to evaluate leverage risk, including academic research-based models that use

company's past fundamental performance to predict the risk of distress and bankruptcy, a company's near-term maturing debt, corporate leverage ratios and recent movement in credit default swap spreads. While our findings indicate the market's broader leverage risk is low, we found several hotspots of elevated leverage that are at greater risk for financial distress. This has allowed our managers to incorporate this risk into their overall evaluation of individual stocks and their financial projections, particularly considering the threat of a recession.

Looking Forward

Many view risk as a four-letter word, a bad thing to be avoided and eliminated if possible. We believe risk should not be defined by terms like good or bad; rather, from a forward-looking perspective, risk is a double-edged sword that can turn out as good risk if an exposure contributes to portfolio performance or bad risk if an exposure detracts from portfolio performance.

It is important to continually adapt to a changing risk environment. Looking forward into 2023, we already see multiple risks within the market: inflation, interest rate, recession and leverage are merely the most visible in a year that will no doubt have its own unforeseen risks. However, rather than shy away from this uncertainty, we have brought an array of quantitative tools and broad viewpoints to help identify and manage risk exposures. We will continue to be diligent in monitoring these and other emerging risks and strive for new and unique ways to give our investment teams the tools to help them make high-conviction decisions.

About the Author



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- 19 years of investment industry experience
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