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Opalesque Exclusive:

Scenario analysis in risk management is now very important, says SunGard
From Sagar Chakraverty, Opalesque Asia

Douglas McArthur, a great American military general, once said: “There is no security on this earth, only opportunity.” Indeed investors worldwide too believed this till 2008 struck. Now they demand greater transparency and better risk management measures from asset managers, and this has changed the marketplace psychology to a great extent.

SunGard, a multinational software company, addressed this new paradigm through its APT division. APT, a specialist in statistical market risk models, risk analytics, and portfolio optimization, has published a white paper called ‘Increasing Transparency with Scenario Analysis –The Third Pillar of Risk Management’ (see here).

Emphasis on transparency
Lochiel Crafter, chief executive of American Risk and Insurance Association (ARIA), said one of the major lessons learnt from the global crisis was hedge funds’ lack of transparency, which arguably led to their downfall. Often not knowing the assets and positions taken by these funds, institutional investors were left out in the cold with little say to investment strategies due to the secretive nature of their operations.

SEI, a global provider of outsourced asset management, published a survey report on 25-Jan-10, entitled “The Era of the Investor: New Rules of Institutional Hedge Fund Investing,” which also revealed that institutional investors are now more interested in transparency than in performance of hedge funds. 80% of the respondents surveyed by SEI ranked portfolio transparency as the number one factor in manager selection.

Eric Bernstein, COO at Sophis, a hedge fund portfolio and risk management solutions provider, said: “This is translating to an increased focus on utilizing real time risk management tools.”

For strategies such as global macro that often invest in liquid securities, passing on that liquidity to investors will be an important step in gaining their trust. SEAL Capital, a Caymans-headquartered asset management firm, which specializes in global macro-strategies, hopes that this explicitly broader focus beyond just performance, recognizing investors' liquidity and transparency concerns, will be a key driver to growing assets. As such, its team will provide investors with weekly liquidity (see Opalesque exclusive said).

APT: fund managers neglected the scenario analysis
Prior to the global crisis, fund managers had neglected the scenario analysis. Many had been using normal-market risk modeling techniques assuming that shocked-market analysis was of less importance. This thinking has changed now. As part of this risk management quest, APT believes that managers will now need more assistance from third-party service providers than ever before.

APT's scenario analysis tool uses 'high panic' market scenarios compared to normal market scenarios as modeling templates. This allows managers to calculate expected loss under different possible negative scenarios. Managers can also simulate multiple shocked-market scenarios from the recent past to gain insight into how their portfolios might perform under similar crisis circumstances.

The APT model
The underlying APT model is economically motivated and takes into account any number of user-defined economic factors. Unlike a pure statistical model, the benefit of this model is that it can allow the customer to make intelligent guesses about the future.

There is flexibility in this scenario analysis tool. A number of explanatory factors are built into the APT economic model so that each factor can work in correlation to one another under different scenarios.

For instance, oil may be the most important factor for a particular company, while other companies might focus on credit spreads, inflation or other potential factors that cause trouble to them. Once the manager decides which factor is most important, the model then shows the relationship between the impacted factor and all of the other possible factors involved.

Aite Group, a Boston-based research provider, predicts that the market for buy-side analytics, which stood at approximately $1.8bn (in 2009), is expected to reach nearly

$3.2bn in five years time. This provides a tremendous opportunity for well-placed risk analytics providers. Source