Kempen Outlook 2021

Managing tail risks

“The coronavirus crisis is the type of event that places tail risk in the spotlight”

When Kempen developed a model that focused on extreme risks in 2019, few people would have predicted that such a tail risk would become reality just a short time later with the outbreak of the Covid-19 pandemic. We asked Fiduciary Manager Frank van der Ploeg what lessons can be learned from the coronavirus crisis, and how our model can help to manage risk in 2021.

In your view, what are the lessons to be learned from the events we’ve seen this year?

“This year has basically been a lesson in humility. Even before the coronavirus emerged in China, Kempen was already working on developing a tail risk model that, as part of our risk-management process, enables us to take into account extreme, unlikely scenarios that may only occur once every 10–15 or even 50 years. We had long been of the opinion that the investment industry was paying too little attention to such risks. The bizarre thing is, of course, that the coronavirus crisis immediately proved the model’s worth. Back in March it was as if the sky was falling in! Everything happened at once: the oil price collapsed, the coronavirus pandemic erupted in all its fury and there was widespread panic in the markets. And the prices of pretty much everything plummeted –something we hadn’t seen since 2009. Things have settled down again since, but this year has been further confirmation that investors focus primarily on return and much less on risk. I expect the entire investment industry to start examining tail risks and how to take them into account more closely. This year has been a true wake-up call.”

What fundamental attitude should investors apply when examining extreme scenarios?

“No one predicted this year’s extreme events, but that’s the lesson we’ve learned from 2020: it’s a mistake to think that you know what may or may not happen in the future. A crash like the one we saw this spring could easily happen again now. Let’s consider an example: everyone’s been talking about the sky-high valuations in the US tech sector recently. But does that mean there’s a bubble that could burst at any time? I don’t think there is, but that’s precisely where this type of model proves its worth: it takes the unimaginable into account. Or look at the oil sector. It has already dropped enormously, which means no one expects it to take a further hit. Yet in theory this is a potential scenario. Climate change is another risk, incidentally one that the current US government refuses to believe in. But what does climate change mean, for instance, for the risk of major flooding in the southern US coastal region, for cities like Miami? And what would such an event and the potential aftermath in terms of policy mean for your portfolio? Nobody knows. And ultimately it doesn’t matter what causes a crash; the important thing is the impact. If we knew the consequences of a crash in advance, there would of course no longer be any risk.”

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Why is risk neglected by so many investors?

“Risk remains an abstract, intangible concept, leading to it receiving relatively little attention from investors. This is certainly true of disastrous scenarios. The chance of them happening is thought to be so small that many investors find it fairly easy to ignore them. The thinking behind this is that you simply have to take risks to get a decent return. What you always want to avoid is that you are taken by surprise and end up being forced to sell, at a very bad time. Incidentally, most professional investors didn’t do that during the coronavirus crisis. Perhaps because they had no choice, or perhaps because they firmly believed in a recovery. I sincerely hope they will maintain that belief during a next downturn.”

Does the tail risk model tell us anything about extreme rebounds, like the one we’ve seen this year?

“Traditional models underestimate the risk of extreme outcomes in the very short term, but they overestimate them in the long term. And that is precisely what happened this year: the huge blow in March was followed by a sharp rebound in April. Such rapid rallies have occurred frequently over the years and they tell us that the impact of a crash has usually flattened out within about a year. The tail risk model assumes that outcomes can go in any direction, including upwards. It doesn’t literally tell you about rebounds – that would be too good to be true. But it does make it clear that the damage caused by massive downturns is ultimately often less severe than expected. Basically, there are not just extreme downward outcomes but upward ones as well.”

What is the value of the model in relation to the new pension agreement?

“Pension funds apply a long investment horizon. The funny thing is that under the present system they’re often judged on their funding level, i.e. in the short term. That’s why we believe it’s so important to keep a keen eye on extreme scenarios. This will only increase in importance under the new, more individually-structured pension system. Instead of a 50-year term, pension funds will become investors with a horizon of just a couple of years in some cases, sometimes even just a couple of days. This has significant repercussions. Members’ portfolios will need to be adjusted more frequently, for example because they’ve entered a different age group. If you need to do that at the exact moment that a tail risk occurs in all its intensity and you experience a loss of, say, 20%, the impact on members will be enormous. This is why we’re going to refer our clients to our model more actively.”

How can the model help to manage risks in 2021?

“The tail risk model focuses on total market risk. You can only manage that to a very limited extent. You can consciously accept or avoid it, but you can’t really control it. This is in contrast to liquidity risk, for instance, against which investors can easily protect themselves. In that sense, the tail risk model is no miracle cure. Yet it can provide assistance in making specific portfolio decisions. Say that as a pension fund you want a less-than-1% chance of having to cut pensions in 2021. The model is useful in this case. It’s purely based on historic data and the basic principle that history tells us something about the future; it contains no subjectivity at all. This makes it a sound tool for taking extremes into account. Apart from risk management, another decisive factor is of course how much return you want to earn as a fund. The conclusion may well be that your portfolio is already aligned as well as it can be with the risk and return

you are aiming for, and a further reduction of risks means you will need to sacrifice some return. That may be unsatisfactory, but the tail risk model is there to get that message across to you."

How would you summarize the added value of the model?

"It can certainly play a positive role for investors. In the short term, the consequences of extreme events are always worse than you think, but the model also makes it clear that the sun always comes back out again in the long term, even after the most extreme of storms. That can remove some of the worry and create a greater sense of calm when stress rears its head again. That's because you know what you are signing up for. This aids rational decisions that you can profit from in the long term. If the model shows you will forfeit an excessively large portion of your portfolio in an extreme scenario, you can adjust it in good time. Of course you will always feel the effects of a storm, but the important thing is that you survive and ultimately come out of it stronger. It's rather like our Dutch dikes, a metaphor we often use when we talk about our model: a dike that can withstand 99.9% of water levels may be able to keep out the water for 999 days, but if it's breached on the 1000th day you'll still get wet."

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