# *Intelligence* MEMOS

From: Henri-Paul Rousseau

To: Canada's Pension Managers

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Re: **A New Agenda for CIOs and CEOs Facing Systemic Risk (Part One)**

COVID-19 has moved the world into uncharted waters. It has forced governments to implement economic and social lockdowns to reduce the virus impacts, while simultaneously adopting unprecedented economic stimulus packages to offset the consequences created by those lockdowns.

The global stimulus response was said to stand at $14 trillion by July 31, exceeding responses to the 2008 financial crisis.

Between mid-February and March 23, as the scope of the pandemic came clearer, the S&P 500 fell 34 percent, leaving investors skittish. It was the fastest decline of its kind in history. This has been followed by the best 50-day rally in the history of the index, which broke past its pre-COVID-19 level last week.

So how should we think about the market, and the economy?

This pandemic is new evidence that the linear trajectory of booms and busts we learned in macroeconomic classes does not accord with the reality I have experienced during my decades in the financial industry. Instead, systemic events –COVID -19, the 2008 financial crisis, the dot-com bust – recur, and each and every one creates major disruptions in economies and societies, changing the multiple relationships on which our investment models and theses are based. Each time, those disruptions create big losers and big winners.

Because of systemic risk, the world bounces from one crisis to another, and each one brings a new investment opportunity set for pension managers and other investors.

Every crisis may be different, but each opportunity set can be sorted with a screen of four characteristics, dubbed VUCA by its 1985 creators. These are Volatility, Uncertainty, Complexity and Ambiguity.

Using these VUCA concepts in the context of pension management, we can better define an agenda for the Chief Investment Officer (CIO) and for the CEO of a fund.

The CIO agenda could be structured by referring to the VUCA investment opportunity set, and the CEO agenda could be prioritized based on the likelihood and the impact of the systemic risks, which I explore tomorrow.

First, the CIO agenda.

The VUCA framework can be used as a guideline to review investment policies, investment process and portfolio construction from a different standpoint.

**VOLATILITY** is generally a source of investment opportunities in liquid markets. A large proportion of revenue for investment banking, hedge funds and large asset managers comes from trading volatility. As trading is becoming increasingly technical and digital, using AI and other sophisticated techniques, large pension funds should have, through partnerships or separately, centres of expertise and excellence in managing and trading volatility on different markets. Failure to do so risks losing sight of a very significant source of information and understanding of market dynamics. Obviously, there is no need to trade and manage volatility on all markets, but there is a need to develop expertise and invest real money in some areas. Digital expertise is crucial to be a market participant as opposed to a simple client of large investment banks.

**UNCERTAINTY**. In an uncertain world, we do not know what we do not know, but it is paramount to identify what we know with certainty and what is not changing. It is also crucial to identify the specific uncertainties underlying the investment thesis of a specific portfolio; sometimes a portfolio of options around the investment thesis will provide a set of augmented bets on the future. Venture capitalists have been investing for years under uncertainty and its high risk of failure; hedge funds have also been very effective in adopting all kinds of strategies and techniques to identify losers and winners. Successful portfolio managers have learned from these experiences.

**COMPLEXITY**. The answer to complexity is the three golden rules of investment: research, research and research. For a very large pension fund, a substantial research budget is a necessity, as the main benefit of size is the capacity to attract, develop and support expertise and talent to address the complexity of the business world, the changing industry dynamic and the complexity of financial products. Underinvesting here is to become more dependent on the big players.

**AMBIGUITY**. In an ambiguous world, the organizational culture plays a key role. It is seldom true that "anything can happen." Most often, the most probable scenarios can be boiled down to two or three options, and contingency investment plans can be developed. Pandemics should have been in there somewhere. Based on my professional experience, the real danger in an ambiguous situation is the lack of explicit leadership and the risk of the dominant "investor" in the room. This dominant player does not need to be the CIO or the CEO, but has great credibility within the organization. They perfectly express the "implicit risk appetite" of the house and have an implicit influence on almost everyone. Assuming this key player is very risk averse, the net result is a broadly lower degree of risk as every portfolio manager has reduced their own risk following the compelling arguments of the key player. The net exposure to market dynamics may turn out to be different and much lower than the expected risk appetite guidelines, and the degree of effective diversification of the overall portfolio may be much lower than the one decided on, as too many portfolio managers adopted implicitly the same conservative macro bets.

It is crucial to verify whether these implicit bets embedded in portfolios are consistent with the explicit assessments of the systemic risks completed under the CEO's leadership. Tomorrow, more about the CEO landscape.

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