

YOUR RISK DICTIONARY

Capital market innovations and changing portfolio theory mean it's time to update your understanding of risk

In the good old days, investment risk was synonymous with business risk. If management watched the books, borrowed prudently, and managed well, the risk of an investment in the company could be understood and fairly measured.

Today, global capital market innovation has taken on a dominant role in shaping business and the real economy. The capital markets have become, in effect, the tail wagging the business dog. The language of risk has expanded to accommodate this new market reality and advisors need to familiarize themselves with these terms:

Volatility Index: The VIX is a commonly used measure of risk sentiment. To oversimplify: The higher the VIX, the greater the market's uncertainty. The VIX is "reverse-engineered" from an options pricing model, using inputs including the current price of S&P 500 Index options, dividend yields, expirations, strike prices and the risk-free interest rate. The VIX implies a volatility number that completes the options-pricing equation.

TED Spread: The difference between the London InterBank Offered Rate (LIBOR) and the U.S. Treasury Bill yield is known as the TED spread. An indicator of liquidity and credit risk, a higher TED number reflects caution on the part of bank lenders. Since LIBOR rates are market-driven and the yield calculations use 90-day instruments, the TED spread is a reasonable gauge of the minimum lending premium required above the risk-free Treasury rate. A narrowing TED can be seen as confirmation of successful efforts to inject liquidity into the lending markets.

Tail Risk: Ninety-five percent of data in a normal, bell-shaped distribution falls within the range of

the mean (average), plus or minus two standard deviations. "Tail" data describes data points outside of that 95% confidence range. Unfortunately, investment markets do not behave in a normally distributed way, and many risk events fall far outside that range. In risk management, "tail risk" has become a popular term for describing risk of rare or unusual magnitude. But describing an event as tail risk may also be a clever way to avoid saying that your assumptions were wrong to begin with.

CDX: The dynamics of Credit Default Swap (CDS) pricing may provide more timely information than debt-rating changes or equity analyst opinions. CDS contracts protect the buyer in the event of a negative credit event (such as a default) in exchange for regular premium payments to the seller of the CDS. The CDX is a series of indices that aggregates a large number of CDSs and provides a broad measure of the cost of insuring against unfavorable credit events.

Counterparty Risk: CDSs and interest-rate swaps are privately negotiated contracts that are largely unregulated and lack a centralized guarantor. Each party to the swap relies on its counterparty's financial strength to fulfill its contract obligations. The popularity and profitability of these swaps have resulted in a proliferation of counterparties and a maze of contractual obligations. There is growing and justifiable concern over who has promised what, and what parties are capable of delivering.

While there are always concerns as new instruments get battle-tested, an updated risk dictionary can help us anticipate and manage risk more effectively. But keeping up with the new world is enough to make you miss the good old days of risk. ■



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* **Tim Knepp, CFA**, serves as Chief Investment Officer of Genworth Financial Asset Management (an Encino-Calif.-based unit of Genworth Financial), as well as chairman of the firm's investment management executive committee. He can be reached at tim.knepp@genworth.com



Genworth Financial Asset Management, Inc.
16501 Ventura Blvd. Suite 201
Encino, California 91436-2007
www.gfaminc.com
To contact the sales department please call:
800 691 6680, option 2.