Insight

Dominion's Risk Management Systems

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Liquidity risk of investment funds has been making headlines in the financial press recently, and for good reasons. Several very high profile investment funds have collapsed because of liquidity risk not having been managed correctly. This 'hidden risk', which is very difficult for investors to assess, can have catastrophic effects on returns if not managed by fund managers.

These high-profile funds that chose to invest in illiquid assets and suffered as a result did not maintain the necessary risk management systems and so put investor capital at risk. But the biggest losers in these cases have been the investors who have had to sit back and watch their asset returns suffer because of the mismanagement of risk by their portfolio managers.

The Dominion Global Trends Funds utilise proprietary risk-management systems to monitor all sources of risk. These systems were developed internally by the Dominion investment management team and have been improved and back-tested for more than 15 years. Liquidity risk is a high priority for the Dominion investment team and all Dominion investment funds have real-time liquidity risk management tools in-place.

Dominion's Liquidity Risk Management Tools

Dominion's portfolio management system constantly monitors the invested levels of every position in each of the investment portfolios, keeping track of a range of different risk metrics in real-time. These monitoring systems allow the investment team to adjust position sizes to ensure liquidity risk is maintained at a very low level.

Dominion uses these systems to determine the initial and on-going size of each investment position to ensure that no single position constitutes a liquidity risk. The investment team does not rely on intuition or guesswork to size investment positions. Instead, Dominion's proprietary systems use quantitative tools to determine the level of exposure each portfolio should take on every stock. The system balances stock specific factors like volatility, trading volume and past performance against one another, ensuring a position size is maintained that can be liquidated in just 24 hours. This is a critical aspect of Dominion's liquidity risk management. The team ensures that at all times, the entire portfolio can be converted into cash with no negative price impact from unwinding those positions. This makes the events that led to the recent collapse of some high- profile investment funds virtually impossible at Dominion.

Dominion's risk management system is structured to maintain a healthy risk profile across all funds, reallocating asset allocations to ensure investors benefit from exposure to risk that generates positive returns. The investment team also double-checks its systems are working properly by using an external risk-manager, who produces reports linked to the liquidity of the portfolios. This third-party risk-manager stress tests Dominion's investment funds to check how long it would take to liquidate the portfolio, even in non-normal (stressed) market environments. Because this system oversees every position in the portfolios, it guarantees the ability to liquidate funds in a single day and therefore remove the risk that investors are unable to redeem their investments in an extreme event.

A Risk Case-Study: Why Dominion Held Apple After Steve Jobs

Dominion operates a 'stop-loss' system as part of its risk management system. This system is triggered when a stock's performance dips below a certain threshold. The system then forces the investment team to re-evaluate the stock in question, challenging them to assess the cause behind the stock's decline, and consider whether it represents a long-term risk to the portfolio or not. This process of real-time re-evaluation is a critical component of Dominion's risk management process –with the systems designed to force the investment team through a data-driven process that removes as much of the "guess-work" as possible.

A straightforward example of the stop-loss system in action occurred when Steve Jobs, Apple's founder and former CEO, passed away in 2011. This caused Apple stock to decline significantly, which alerted Dominion's stop-loss system. The stop-loss system, in turn, alerted the fund manager of the portfolio, which owned stock in Apple. A research process was initiated wherein the portfolio manager analysed the mid-term and long-term effects of this event on Apple's business prospects.

Dominion decided to retain its position in Apple. This is because, despite a significant share price decline following the news event, longer-term factors for the business remained positive. Apple still had a great business story and a strong brand. It had a notoriously strong management team: Tim Cook, the successor to Steve Jobs, was already in place, and had been running the company for months. Its design pedigree, which had spurred demand for its products, remained unquestionable, with legendary designer Jony Ives still at the helm and while Apple's pipeline was long and impressive.

The Dominion team concluded that other Apple investors were panicking over the what-ifs – a natural result, given the powerful cult of personality Steve Jobs had established. All the data pointed to a company that was well prepared for its superstar-CEO's demise, and as a result, the Dominion portfolio manager in question took the (correct) decision to hold the stock. By the end of that day, the stock had closed up. And in the years following, Apple would become the world's largest company by market-capitalisation.

Dominion's risk-management systems are driven by quantitative tools but also are complimented by the experience of the investment management team. Together, the quantitative systems and investment experience of the team allow Dominion to operate a flexible risk management system that does not react automatically to risks but instead uses automated systems to guide real-world decisions by the team. These systems also ensure that Dominion never risks investor capital in illiquid investments, or by acting irrationally in response to short-term news (as in the Apple example). These systems do not manage the funds directly (Dominion believes that decisions are best-made by people, not computers), but these systems do enable Dominion to manage its investment funds in an optimal way, balancing risks and investment returns.

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