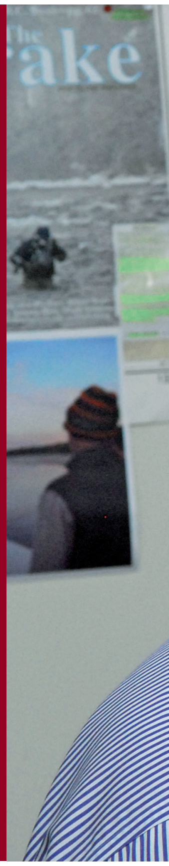
# Fritz Folts (MBA '91)

# Navigating Risk During a Downturn



Fritz Folts (MBA '91) is a principal and investment committee member of Windward Investment Management, an investment advisory firm serving high net worth individuals, trusts, retirement plans, foundations and endowments. It currently manages over $3 billion in client assets. Folts credits IESE with giving him a more global outlook and helping him discover his entrepreneurial spirit.

**Despite high unemployment and shaky confidence, the markets are remarkably buoyant. Why is this?**
It is important in our business not to confuse the market with the economy. When a market declines to the extent that we experienced from January 2008 through March 2009, there is a natural tendency for the markets to experience a bounce-back rally at some point. Since the current market low in March, the global equity markets have bounced back dramatically. Year to date, the S&P 500 is up over +20%, and Chinese equities have increased by over +50%. It is like bungee jumping, the farther the market falls in any period, the more dramatic the bounce-back seems to be. However, oftentimes these bounce-back rallies turn out to be simply bear-market rallies which eventually run out of gas, at which point the market turns down again. Furthermore, particularly in the U.S., as the economy continues to struggle and unemployment remains a problem, the Federal Reserve is forced to maintain its extraordinarily stimulative monetary policy, including short-term interest near 0%, in an attempt to reverse deflation and support economic recovery. The global equity markets have been major beneficiaries of these monetary and fiscal stimulus programs, which have had the effect of reflating asset prices.

**Does this buoyancy mean the central banks' strategy of bailing out failing institutions is working?**
Immediately following the collapse of Lehman Brothers, there was a real sense of foreboding throughout the global

capital markets. There was a feeling that, at least here in the U.S., we were heading towards a potential collapse of the banking and shadow banking system and towards the real possibility of another great depression, similar to the 1930s. Even though the bailout of Wall Street and the banks was administered as a rather blunt instrument, I believe that their actions did help to avoid the potential of an even worse calamity.

**The central banks have increased liquidity. Could this just be fuelling the next bubble?**

Yes, the enormous degree of liquidity which has been made available, at least in the U.S., by holding short-term interest rates at basically zero, combined with aggressively employing quantitative easing, which is the equivalent of printing money, is raising the risk of inflating the next asset bubble. The U.S. fiscal deficit is projected to more than triple over last year as the U.S. government attempts to bail out consumers, businesses and banks by shifting their debt onto the U.S. Treasury's balance sheet. This extraordinary monetary and fiscal stimulus can be supportive of higher global equity prices in the short to intermediate term but typically results in currency devaluation and increased inflationary pressures over the longer term.

**What regulatory changes need to be made?**

I'm not sure exactly, but I do think that for one thing there needs to be greater transparency, particularly in the derivatives market with instruments such as Credit Default Swaps (CDS), etc. For example, AIG was for the most part a fairly conservative insurance company, but it was brought to its knees by a small group in London called the AIG Financial Products Group (FPG), which was recklessly entering into Credit Default Swaps (basically insuring corporate credits) with absolutely no regard for risk management and with no capacity to meet their obligations should there be a problem in the economy or the markets. However, there was no transparency in that market, no central clearing house or exchange and therefore no way to understand the level of risk that AIG FPG was piling up alongside their enormous annual bonuses.

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Also, in my opinion, there needs to be additional specific regulation around the use of leverage on Wall Street, in banks and in the shadow banking system (hedge funds, etc.). The crisis that we experienced in 2008 was essentially a *credit contraction*. A situation in which, through de-leveraging, liquidity is extracted from the financial system.

**Do the regulators need to educate themselves? For example, do they understand risk?**

In the U.S., at least, I am often surprised and disappointed by how little most members of Congress understand about the financial markets. On the other hand, I do believe that U.S. Treasury Secretary **Geithner**, Federal Reserve Chairman **Bernanke** and President **Obama**'s advisors, such as **Larry Summers**, et al., do understand the global capital markets and risk. However, the issue here is that these individuals may just simply be too close to Wall Street to be effective.

**Is risk a dirty word now?**

I would say that investors have been re-introduced to financial market risk by their recent experiences. However, the root of the problem is that financial markets are simply far more volatile than modern portfolio theory and the efficient-market hypothesis leads one to believe, which in

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turn entices investors to ultimately take greater market risk than they realize.

**The general public views the bonus culture as being at the root of the crisis. Is this justified?**
I think that Wall Street's structure, where the majority of one's remuneration is through an annual bonus, is not necessarily conducive to responsible behavior. What would be more helpful, perhaps, would be a system where one is paid out over a longer period for longer-term success and not just making a killing one year with a product that could bankrupt the firm the following year. A bonus system that rewards long-term, sustainable success would help to force folks on Wall Street to consider not only short-term reward, but also longer-term risk in their decision making and their actions.

**Your firm says that "volatility" by itself is an incomplete measure of risk. Could you expand on this?**
Yes, we do believe that volatility is an incomplete measure of risk because it relies on the bell curve (normal distribution) by measuring the degree of variation of returns around the mean or (average) return. We simply reject normal distributions as the basis for making risk-management decisions, given that we believe investment returns fluctuate in accordance with a power law [which holds that small occurencies are really common, whereas large instances are extremely rare] rather than a Gaussian distribution [used to describe any variable that tends to cluster around the mean]. Therefore, we use a multi-objection function to analyze investment risk, which looks at not only volatility but also maximum drawdown, with the goal of maximizing risk-adjusted return and simultaneously minimizing portfolio drawdowns (declines).

**Have investors become more risk averse?**
Again, I believe that investors have been re-introduced to market risk for now, based on recent experiences. But I have also seen that, as this rally in global equities continues, investors are feeling, not the pain of losing money in the market, but rather the pain of feeling that they are missing the current rally by being in cash as a result of the market meltdown in 2008.

**Has the efficient-market hypothesis, that price reflects all the relevant information in regard to value, now been discredited?**
I would say yes, the efficient-market hypothesis has been discredited. However, surprisingly, it is still the basis for most traditional investment analysis. Our basic premise at Windward is that we reject both modern portfolio theory and the efficient market hypothesis as overly simplistic. They are useful but insufficient.

**In general, how can the financial sector become more responsive to society?**
Tough question. In my view the investment-management and the brokerage industry has not really told its clients the truth about risk. This is partly because they have a tendency to underestimate risk, but also they avoid talking about it because they're afraid of scaring their clients off. On the client side, clients are looking for certainty. They want to be told the market is going up, so they are ripe to listen to these half-truths. That has to change.

**How did you come to choose your current career path?**
I've always been a fairly good global, macro thinker; able to see the big picture and that fits well with how we approach the market at Windward. And I've always had an interest in global politics and this has all come together here, though it took me a while to realize this was what I wanted to do.

**How has your education here at IESE helped your career?**
I gained three things in particular. One was the development of my capacity to have a global perspective and focus. More than anything, that came from being around so many students from so many nationalities and cultures and realizing that there are a lot of different ways to look at the world. The other thing is the emphasis there on ethics. The third thing was the spirit of entrepreneurial thinking, that it's important and is to be celebrated. IESE helped me realize that that's what I wanted to do.