DEC 2025

Navigating Risk: The View from the Crow's Nest

Despite everything that's transpired this year—from the reshaping of global trading arrangements to persistent fiscal excesses to geopolitical strains—stock indexes are undeterred and continue to hover near all-time highs. Credit spreads are historically tight. Many speculative assets have surged. AI's audacious promise is captivating investors. And, on the premise that interest rates are somehow too restrictive, the Federal Reserve has begun to reduce them.

The market's winds are favorable for now. Stocks have nearly doubled in three years. But whether you're bullish or bearish about the future, we believe your portfolio must always accommodate the unavoidable reality that you don't know what will happen next.

Surprises are inevitable, and the bouts of volatility we've endured this year have underscored what we see as the four core dimensions of sound risk management:

1. a thoroughly developed investment policy,
2. a disciplined rebalancing framework,
3. a willingness and ability to capitalize on dislocations, and
4. a collaborative, dynamic team culture.

For the stewards of multi-generational capital, through calm seas and rough, a coherent approach to risk management is not peripheral; it is the work. We believe it is central to the job of generating durable, long-term returns.[i]

The Long View

from the desk of Matt Bank
Co-CIO
GEM

The State of Nature

Let's begin by dispensing with the conflation that underpins a lot of unproductive debates about portfolio management: **volatility is not risk, and risk is not volatility**. There.

Risk is bigger than any number, of course. It's a state of nature. In statistical terms, it's the distribution of possible outcomes around an expectation. Or, as Elroy Dimson said plainly, "risk means more things can happen than will happen."[ii]

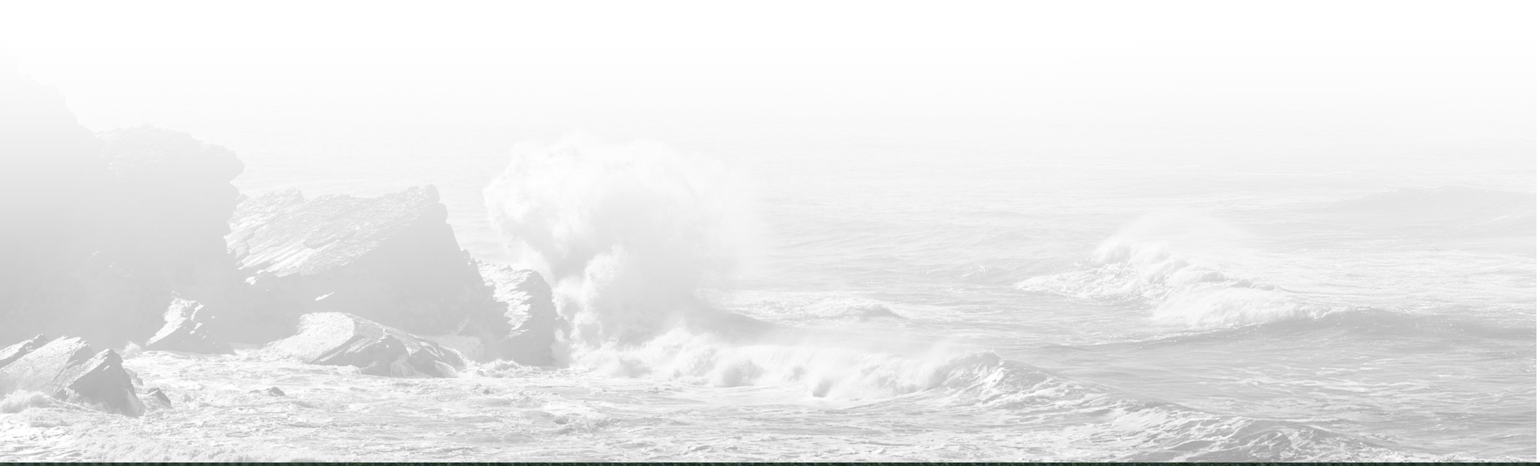
We're not simply at the mercy of chance, though. We have some agency. In his seminal book, *Against the Gods*, Peter Bernstein reminds us that the word "risk" derives from the Italian *risicare*, meaning "to dare." In other words, **risk is a choice**. Decisions to base jump, to free climb the face of Yosemite's El Capitan, or to invite your coworker to a Coldplay concert change your exposure to risk in obvious ways. But every choice we make in any facet of life reshapes our relationship with the probabilities and consequences of future events.

We often have to make those choices with imperfect information. And in markets, risk is a shape shifter, manifesting in different ways and evolving over time. In his 2014 essay, "Risk Revisited," Howard Marks rattled off two dozen different types of risks and acknowledged he was leaving plenty out:

> "The risk of losing money, the risk of falling short, the risk of missing opportunities, FOMO risk, credit risk, illiquidity risk, concentration risk, leverage risk, funding risk, manager risk, over-diversification risk, risk associated with volatility, basis risk, model risk, black swan risk, career risk, headline risk, event risk, fundamental risk, valuation risk, correlation risk, interest rate risk, purchasing power risk, and upside risk."

A single investment could comprise a dozen of these; a portfolio, all of them simultaneously. Some are analytical challenges, some are behavioral issues, and some reflect a world with a stubborn tendency to deviate from our spreadsheets. But regardless of source, **risk is the price we pay for the chance to grow wealth and meet our future liabilities.**

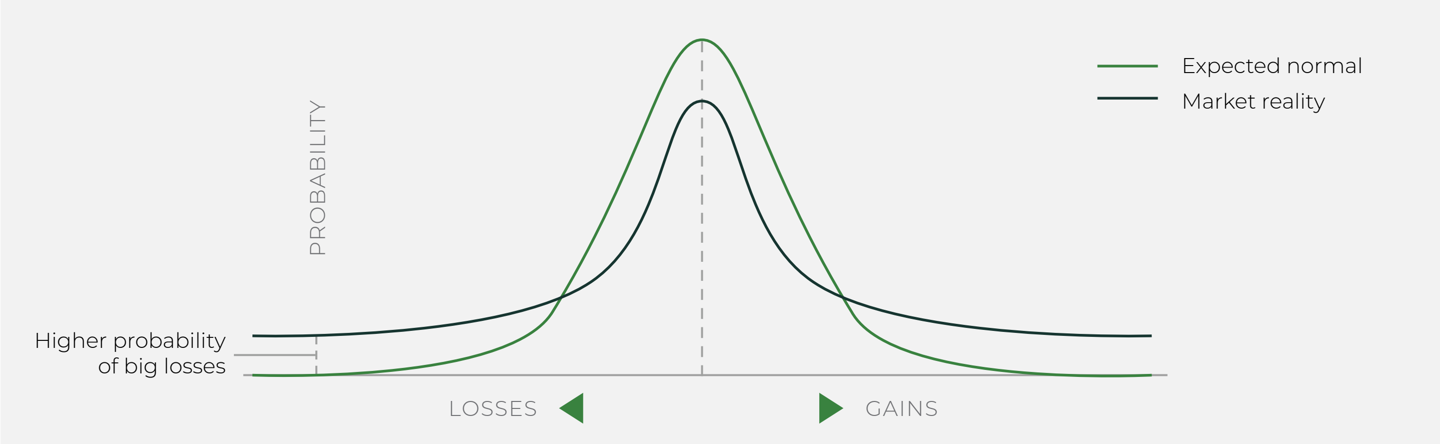
The key questions for long-term investors include: what kinds are you willing to endure, how much, and how do you control your exposure to each through time?



The Lessons of History

Benoit Mandelbrot liked to say that "markets are far riskier than we think,"[iii] and he was right. Episodes of turbulence are more common and more devastating than normally distributed models would predict.

Distribution of Outcomes



Source: GEM analysis.

Whether equity markets unravel alongside a web of misunderstood leverage as in 2008, or on the spread of a novel coronavirus as in 2020, or in response to the trade policy hallucinations of the leader of the free world as in 2025 doesn't matter all that much. The overwhelming lesson of history is that, amid all the constants that Will and Ariel Durant used to write about—human nature, cycles of power and war, civilization's fragility, et cetera—the world and the capital markets in it will surprise you. **How you prepare for and deal with the consequences of surprise is risk management.**

That task is as beguiling today as ever, in part because of the flood of data available to examine portfolios and the near-endless tool set we have to tinker with them. Making a similar observation on a different topic, the philosopher Alan Watts wrote in 1951: "We know so much detail about the problems of life that they resist easy simplification, and seem more complex and shapeless than ever."[iv] The anxious modern allocator faces a profound paradox of knowledge.

Within the portfolios he/she manages, diversification still cures a multitude of ills. Spreading your bets and selecting assets that you believe will behave differently from one another under stress is always part of the risk management playbook – it's "the only rational deployment of our ignorance."[v] But it's not sufficient. How you prepare structurally, behaviorally, and organizationally to make decisions in the face of uncertainty; to properly calibrate the tension between conviction and humility; to endure the discomfort of doing the right thing at a difficult time; and to incentivize your team to engage in the right level of self-critique are all key to defending and growing assets.

We are not in the crystal ball business. We are in the business of nurturing the conditions under which a portfolio can thrive, regardless of how the world unfolds. **If the antidote to surprise isn't clairvoyance, then it is process.** It's the playbook that turns expectation into sensible decisions.

The Playbook

GEM's clients—endowments, foundations, families, health systems, sovereigns, and other long-term asset owners—typically have perpetual goals alongside perennial claims. Whether for operating budgets, philanthropy, strategic uses, or passing wealth on to children or grandchildren, their draws on capital necessitate a coherent and holistic approach to navigating risk, particularly through periods of market unsteadiness. Our risk management framework is crafted specifically for them, and it's comprised of four elements.

1. **Clarity:** A well-crafted Investment Policy Statement, designed in alignment with a client's specific goals and risk tolerance, that codifies the guidelines around which assets should be deployed.
2. **Discipline:** Active rebalancing that forces an investor to course-correct allocations around long-term or tactical targets.
3. **Opportunism:** A capacity and willingness to adapt the character of portfolio risk in periods of undue calm or panic.
4. **Culture:** Cultivating the right behaviors, incentives, and governance structures that enable rational, bold choices amid uncertainty.

We'll summarize the principles and some of the nuances of each.

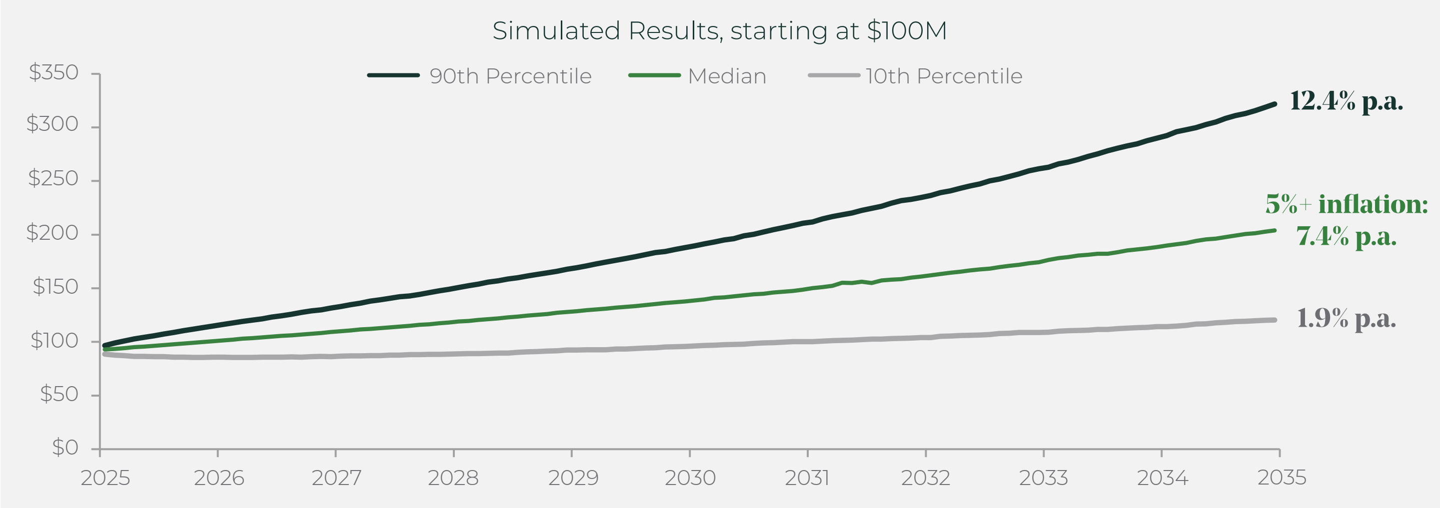
1. Investment Policy: The Blueprint

We've written and spoken extensively elsewhere about Investment Policy Statements (see here, here, and here, for example) so we won't belabor the topic. Suffice to say, the IPS is viewed by too many fiduciaries as a mere bureaucratic artifact – written once, vaguely specified, reviewed infrequently. It ought to be given far more respect. It is the investment program's compass, defining the portfolio's purpose, goals, target allocations, liquidity needs, benchmarks, and the roles and responsibilities of those parties overseeing it.

We insist that an IPS tackle at least these "Four Horsemen" of portfolio risk:

Shortfall, or long-term, absolute risk: What is the money for, and what are the consequences if you don't meet your objectives? While you cannot engineer returns that the market isn't priced to deliver, with reasonable capital market assumptions and a clear sense of the costs of failure, you should be able to target a specific probability of meeting long-term goals. An endowment committed to intergenerational equity, for example, might target a 50% probability of achieving its spending rate plus inflation.[1]

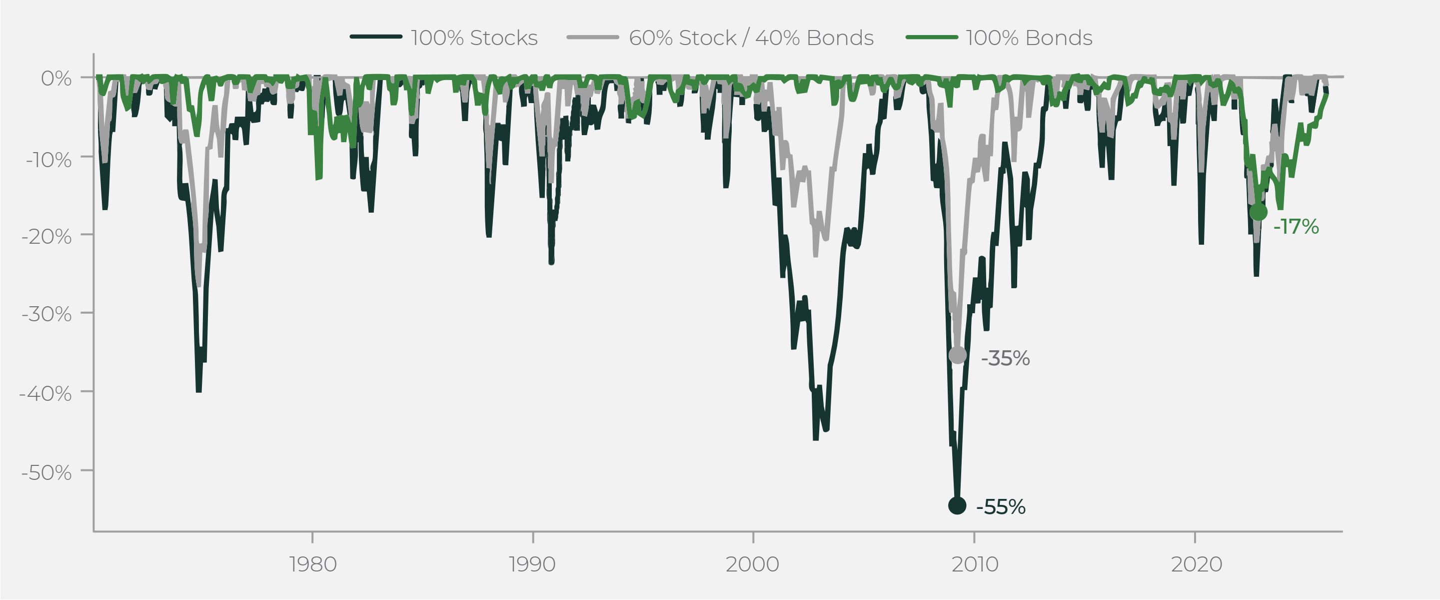
Cumulative Wealth After 10 Years[vi]



Source: Augur Labs.

The more aggressive your return needs, the more you must be willing to accept **Drawdowns,** or short-term, absolute risk. Because many of our clients require annual (or more frequent) draws from their investment portfolios, they're concerned not only with the portfolio's end-state return, but also with the path of those returns. How much of an interim portfolio decline can you and an operating budget tolerate? Quantifying that figure prepares everyone involved to expect and withstand inevitable rough patches.

Drawdowns since 1970[vii]

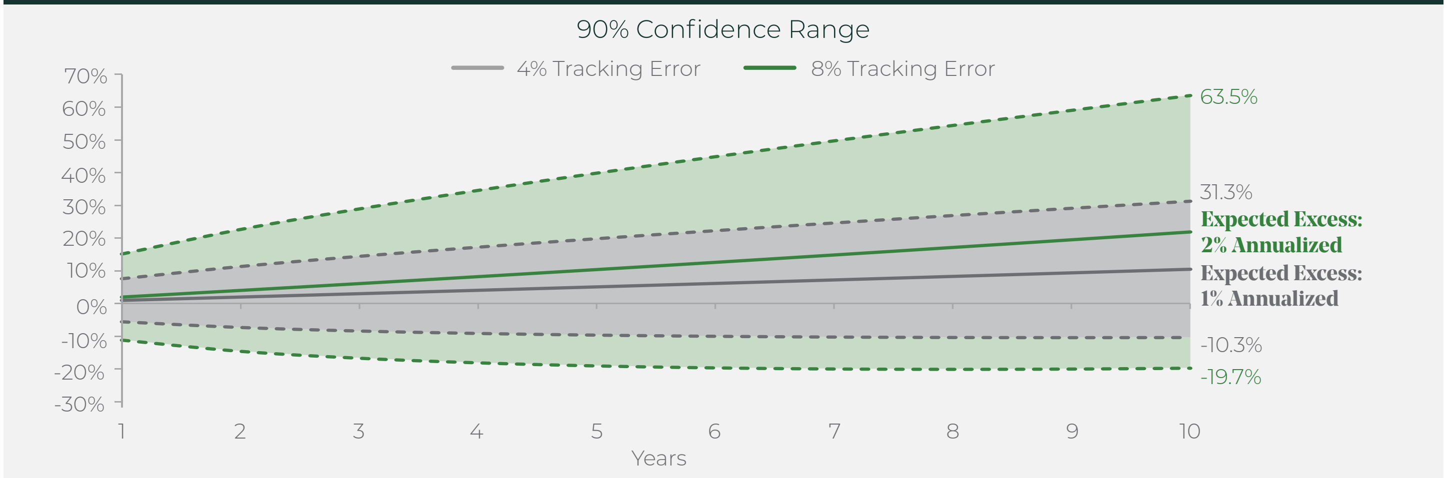


Source: Augur Labs.

[1] Implicitly or explicitly, most large universities target a much higher probability, gearing their endowment portfolios for real growth.

To control drawdown risk or to extract market-beating returns, you must accept **Variance,** or short-term, relative risk. How much underperformance versus peers and benchmarks are the stakeholders around an investment program willing to bear? Looking different from others is a necessary condition for long-term outperformance, but some groups have a harder time than others governing effectively through the inevitable periods of underperformance along the way. Specifying a target tracking error, or active risk budget, and proactively discussing what can happen in the tails of the distribution ensures aligned expectations.[2]

Cumulative Excess vs. Benchmark[viii]



Source: GEM analysis.

And finally, there is **Illiquidity,** or access-to-capital risk: How much money will an institution need under worst-case market and operating conditions? And can a portfolio satisfy those organizational demands with enough liquidity left over for rebalancing? This is both an operational question and an investment one, and requires extensive ongoing coordination between an investment team, finance team, and strategy-setting leadership team. For any given client, a) a more dynamic operating environment, b) a higher average spending rate, c) more potential variability in year-to-year spending, d) higher correlation between spending needs and market conditions, and e) more limited reserves or inflows all point to a lower tolerance for illiquidity risk.

You'll note that these risks often conflict with one another—for example, less tolerance for drawdowns can increase shortfall risk—and trying to suppress one typically requires accepting more of another. Nevertheless, specifying them all in advance provides useful connective tissue for decision-making.

The most obvious linkage is to an asset allocation, which translates those risk metrics into the language of investment choices, establishing a neutral risk posture, formalizing the types and degrees of diversification, and constraining overzealous reaction functions. We, like everyone else, use an asset allocation model to help us set the course. In our process, we are constantly refining how we estimate expected returns, lean on conditional value at risk and other risk outputs other than standard deviation, disassemble alternative assets into their core, underlying risk contributions, and incorporate various methods to account for the observed oddities of portfolio return streams, including autocorrelation and volatility clustering.

Models only take you so far, so we run scenario analysis across dozens of historical episodes, stress test melt downs and melt ups, and maintain an active connection with our judgment to pick the asset mix that best harmonizes with client goals. There's no silver bullet here, but it is rigorous. We often see portfolios that are under-diversified, over-diversified, or simply mis-specified relative to a client's unique imperatives. And we see plenty of others where such imperatives aren't articulated at all in a tightly drafted IPS. As they say, if you sail past the harbor, it's rarely the harbor's fault.

[2] For investment purists, this is perceived as the most cowardly risk of all. But as anyone managing Other People's Money (and especially Other Committees' Money) learns, keeping institutions in a portfolio they can live with is as important as building an optimal portfolio.

2. Rebalancing: The Commitment

Rebalancing is like warm apple pie to allocators: a well-accepted staple. It assumes that the portfolio's strategic allocation—thoughtfully designed, stress-tested, and governed—reflects the optimal balance between risk and return across regimes. As prices move, those weights drift, and so does the portfolio's risk profile. Rebalancing is a tool of mean reversion: trimming what has become too dominant, replenishing what has been diminished. But like any tool, it only works if it's used **consistently** and **with intention**.

"Consistently"

One of the most common pitfalls during periods of stress or exuberance is neglecting to rebalance. Doing so runs counter to the typical emotional impulse, which is to simply extrapolate recent momentum – hold more of the thing that's worked, and less of the thing that hasn't. But that's precisely why rebalancing must be process-driven. The point is not to time market turning points, but to respond to divergence from the plan and bring the portfolio back into alignment. If the market continues moving in a similar direction, you simply do it again whenever allocations drift beyond acceptable ranges. We will rebalance as needed with a frequency suited to the instrument: weekly, if broad risk factors diverge meaningfully from desired targets, monthly or quarterly for asset classes or managers, and always pursuant to a disciplined position sizing framework.

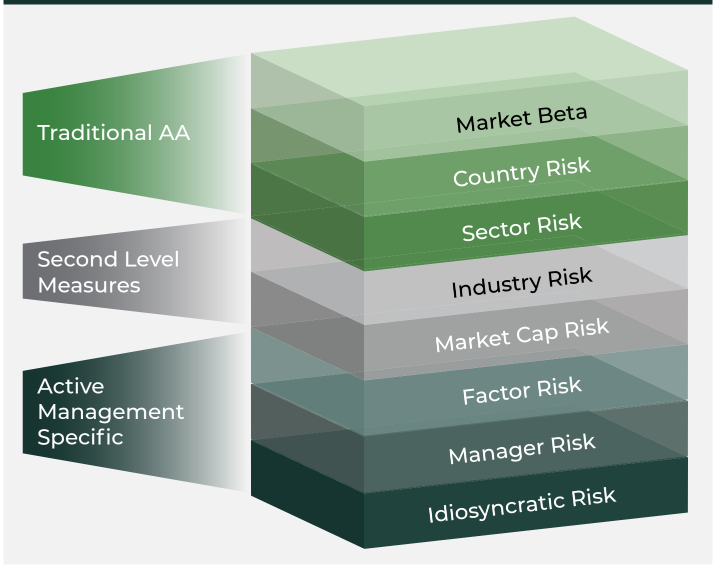
"With intention"

It sounds simple, but active rebalancing shouldn't be blindly reflexive. There are a few **complicating factors:**

1) Layers. In portfolios diversified across risk factors, asset classes, styles, sectors, geographies, themes, strategies, managers, and securities, there is always the question of what to rebalance from and into. If looking to reduce beta, what do you sell? Equities, high yield bonds, REITs? If equities, which ones? Consumer staples or tech? And how do you reduce exposure, via manager redemptions or through hedges? Because we have the tools necessary to effect exposures in essentially any manner at any layer of the portfolio—from overall beta down to a single security through every tradable instrument—we have to establish target weights around a variety of portfolio attributes, not just top-level asset categories.

Adjusting exposures on one risk dimension (adding US equities, for example) has consequences for other risk dimensions (like increasing the weight in the technology sector). There are also novel cross-category linkages emerging all the time. The Magnificent 7 stocks have, at times, been their own monoculture. More recently, the AI theme has been a key binding agent across a range of assets including cloud hyperscalers, semiconductor manufacturers, commodity providers, power producers, pipelines, data centers, and others. This multi-layered portfolio evaluation, we believe, demands position-level transparency and robust analytical tools. We continuously evaluate the contributions to tracking error of any given security, allocation tilt, or manager, aiming to be sure every position is purposeful and understood.

Relevant Risk Layers within Public Equity Portfolios



Source: GEM analysis.

2) Tactics. Thoughtful rebalancers also regularly consider the merits of deviating from the long-term targets. There are two reasons you might set and rebalance to distinct tactical weights:

> Client-driven: The mix of risks a client can tolerate evolves through time. During the Covid drawdown in March 2020, for example, many hospital systems and universities faced highly correlated operational and market risks: declining portfolios coinciding with acute revenue and/or cost pressures, and hence the potential for greater portfolio dependence. By forgoing rebalancing back into equities, we reduced absolute portfolio risk and accepted higher benchmark-relative risk. It made sense then for those clients, even in hindsight.
>
> Market-driven: Our assessment of where we are in the business cycle will influence our desired exposure. Is the risk of unanticipated inflation high? Lean toward commodities. Is there a whiff of deflation as the labor market weakens? Tilt toward Treasuries. Business cycles are patterns, and asset types behave differently during different phases of that cycle.

We aim to ensure tactical tilts never swamp more reliable manager-driven excess returns by constraining the tracking error from asset allocation to less than 1%, or no more than 10-15% of our total active risk budget.

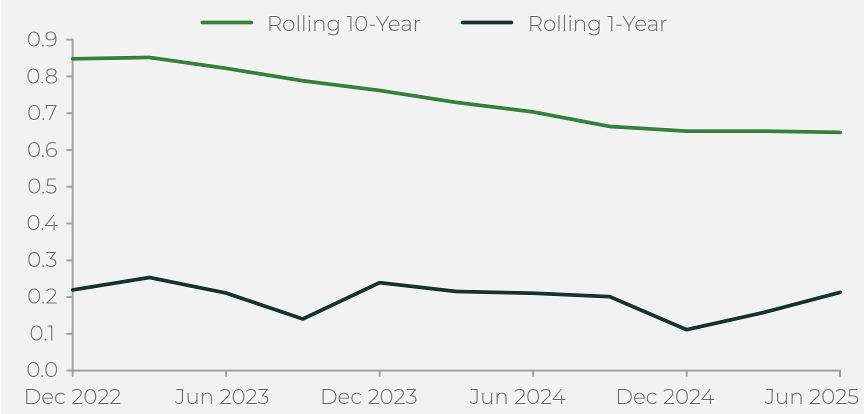
3) Privates. Illiquid assets aren't easily rebalanced, of course.[3] They also tend to display deceptively low beta in the short run. Over a full cycle, private equity behaves much like public equity, but over shorter intervals the relationship breaks down. That creates an intertemporal risk management challenge.

When public markets decline, the percentage allocation to privates tends to rise mechanically, since their values adjust more slowly. In theory, you'd love to monetize that "diversification" benefit by selling private assets to buy public ones. In practice, you can't.

Instead, when the opportunity arises, allocators can adapt elsewhere: temporarily take bonds below target, rotate from lower-beta liquid assets into higher-beta ones, shift the equity mix away from defensive sectors, or even add modest leverage, provided your liquidity position allows for it. Each of these actions can restore the intended balance of risk across horizons.

We believe all of these decisions require care and discipline and emphasize process over outcome. Rebalancing, at its core, is a humility strategy.

Private Equity Realized Stock Beta[ix]



Source: Bloomberg and Burgiss.

[3] That's why the bar for deploying an illiquid budget in diversifying asset classes should be extremely high. Those are the things you need to sell when markets are down, and illiquidity prevents it.

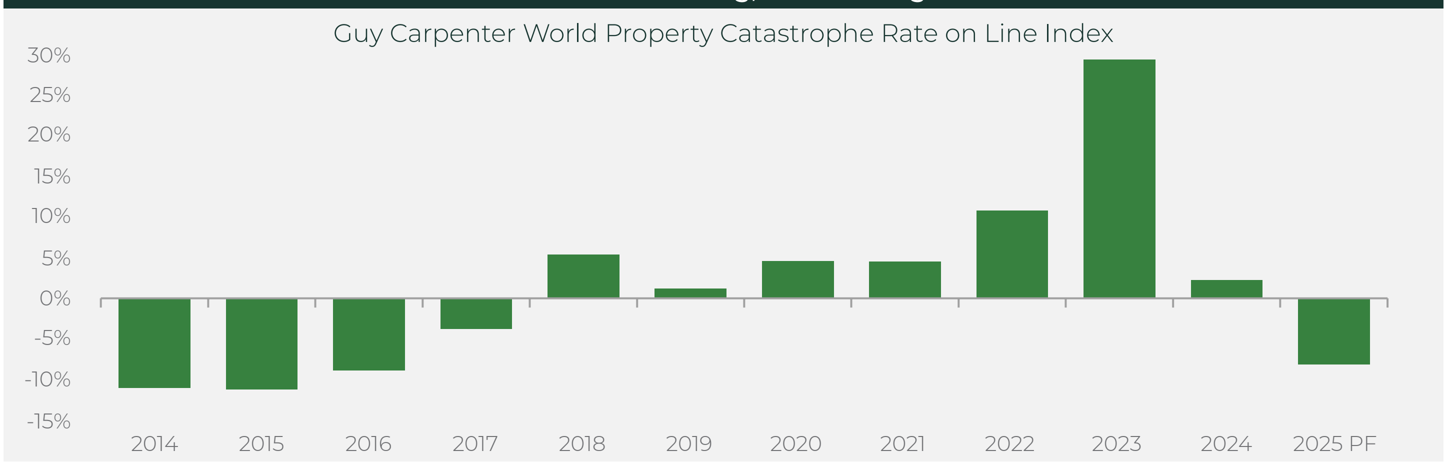
3. Opportunism: The Discretion

If rebalancing is about risk containment—keeping exposures tethered to portfolio design—then opportunism is about risk transformation—reshaping a portfolio's distribution of outcomes by capitalizing on swings between greed and fear. One maintains alignment with long-term intent, the other exploits short-term inefficiencies. One restores equilibrium, the other rewards disequilibrium. **Opportunism is the purposeful redeployment of risk exposures when the distribution of possible future states of the world suddenly shifts.**

We may take opportunistic positions for offensive or defensive reasons: either to improve upon or protect the upside potential of the portfolio, or to mitigate the downside probability or consequences of adversity. In that sense, opportunism is about improving the shape of a distribution around a consistent portfolio expectation.

On the offensive side of the ledger, we look for moments when the distribution of outcomes skews to the upside, often when capital has run the other way. We can, for example, buy "right-tail" insurance in the options market when prices are attractive. Or we can make enhancements to the manager roster. Following the devastation of Hurricane Ian in 2022, reinsurance was a hated area. The industry suffered from trapped capital after years of higher-than-average insured losses; primary insurer bond portfolios lost value as interest rates climbed, forcing more risk off their balance sheets; and spiking inflation caused insured values to rise quickly. It all created a sharp mismatch between the supply and demand for reinsurance capital. We studied the various pockets and access points—retrocessional, quota shares, industry loss warranties, catastrophe bonds, et cetera—and scaled exposure quickly. The past couple of years proved to be among the best reinsurance investment environments in a long time.[x]

Reinsurance Pricing, YoY % change[xi]



Source. Guy Carpenter. The Guy Carpenter ROL index is a measure of the change in dollars paid for coverage year on year on a consistent program base

Defensive opportunities, by contrast, typically are best implemented during quiet markets—when valuations stretch, risk premia compress, and "left tail" protection is cheaper. We've used a range of approaches: short futures to manage specific geographic or industry exposures, put spreads on high-yield indexes when spreads tighten beyond reason, breakeven inflation swaps when market pricing diverges from our inflation outlook, and, at times, selective currency hedges.

These sorts of positions are never established in a vacuum, but always relate to portfolio architecture. Some investors, so afraid of the left tail, run consistently with tail-risk strategies or long-volatility funds to protect their flank. In general, we think those strategies are a bum deal. We prefer to run with less aggressive asset allocation on average and use hedges strategically to address any specific risks that are either overly or insufficiently reflected in the portfolio.

Opportunities may come about in the form of co-investments, secondaries, dislocated sectors, liquidity-starved niches where capital has fled, or in the pricing of individual trades. We also pay close attention to when a manager calls us, pounding the table on the attractiveness (or, less often, the expensiveness) of their portfolio or opportunity set. We especially pay attention if they don't call often. We've added to managers during every crisis over the last several years and trimmed our allocation to one more recently after he flagged concerns regarding valuations in his market, all to good effect. Opportunism via external manager relationships, we've learned, depends as much on earned trust as on insight.

But the essence of it—offensive or defensive—is a willingness to prepare for and engage with a rapidly changing environment. Mitigating downside or capturing upside opportunistically is not about abandoning discipline; it's about having the flexibility to act when the odds temporarily stack in your favor. This requires dry powder, decision authority, and the confidence to steer into the storm.

4. Culture: The Foundation

Having a sound playbook helps, but execution depends on something deeper: a culture that can hold its shape when the world bends. **Culture is the unseen framework of decision-making**; it is the habits, instincts, and relationships that carry an organization through ambiguity. It's what shows up when process runs out.

Many firms treat risk as a support function: a committee, a dashboard, a title. We've learned that bureaucracy rarely moves fast enough. Equity markets correct on average every four years,[xii] and crises don't pause for governance calendars. In those moments, speed, trust, and shared understanding matter more than any protocol. These virtues are hard to find in volunteer committees meeting quarterly in consensus-oriented environments. And consider the layers of large asset management organizations, which burden decisions precisely when they should accelerate them. Successful crisis management depends on proximity, openness, and truth-seeking, not process theatre.

We believe GEM is organized for that reality. The team runs a separate pipeline meeting for each asset segment, reviewing opportunity sets and exposures. The Investment Committee meets weekly, not to rubber-stamp decisions but to test them. Every two weeks, the senior team steps back to look across the portfolio: liquidity, concentrations, pacing, specific manager issues and opportunities. Once a month, the client team revisits portfolio alignment and implementation. Between those conversations, information moves freely. Dashboards and risk reports are open to everyone; anyone can surface a concern or idea. Office doors are open.

When volatility rises, the pattern tightens. We meet more often, sometimes several times a day, formally and informally. Risk reports update more frequently. Communication becomes continuous. There's no ritual to it – just a steady effort to stay connected, to see clearly, and to act together. The question is always the same: what's the right decision for the client, in line with our understanding of their goals and with the specifications we laid out in the IPS?

That approach is reinforced by who we hire and how we reward. We look for people who stay curious under pressure, who can argue a point without making it personal, who worry about truth over credit. We compensate for contribution and clarity. The goal isn't to eliminate error but to keep learning. The most successful investment teams all cultivate environments where it's safe to disagree and it's expected to reflect. They operate with humility in the face of uncertainty and with discipline when conviction seems scarce.

An OCIO search consultant recently told me, "This pains me… but the world doesn't care about culture, integrity, or trust." Maybe not, at least not after a fifteen-year bull market. But when returns ebb, the tide goes out, and the easy narratives collapse, we believe those will be the only things that matter.

Lone Pine's founder Steve Mandel recently said, "The investing world needs more organizations purpose-built for excellence, forged from first principles, designed to endure and thrive for the long haul."[xiii] That's the aim—culture as an enduring system of clarity and accountability.

Closing: Embrace the Craft

Risk management isn't a department. It's a way of thinking—an attitude of humility before the unknown. Each morning begins with the same question: **What might we be missing?** Not in fear, but in vigilance. Great investors don't chase certainty; they practice awareness.

The strongest portfolios aren't built to avoid risk. They're built to navigate it—with structure, with clarity, and with trust in the process. The enduring teams establish clear allocation directives in governing documents, rebalance not out of habit but out of respect for discipline, seize opportunity in dislocation, and do so with organizational alignment.

The legendary investor and mathematician Ed Thorp once observed that understanding and managing the trade-off between risk and return is "a fundamental, but poorly understood, challenge."[xiv] Few master it. That's the real craft. It lives in the small, unglamorous repetitions: reviewing exposures, revisiting assumptions, re-anchoring to purpose. It's patience over impulse. Reflection over noise. The quiet confidence of consistency.

We can't control the sea. But we can know our vessel, read the currents, and maintain a steady hand.

Matt Bank
Co-CIO, GEM

ABOUT GEM

GEM is an independent investment management firm that provides customized solutions for long-term investors worldwide. Since 2007, we have sought to deliver superior risk-adjusted returns to our clients by combining disciplined investment research and active portfolio management with exceptional service and enduring partnership. With a global platform, broad institutional investment capabilities, and an experienced team, we design portfolios to meet the unique needs of each investor we serve. For more information, visit www.geminvestments.com.

Connect with our team:
gemteam@geminvestments.com

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ENDNOTES

[i] Returns are not guaranteed.

[ii] Howard Marks, The Most Important Thing, 2011

[iii] Benoit Mandelbrot, The (Mis)behavior of Markets, August 2004

[iv] Alan Watts, The Wisdom of Insecurity, 1951

[v] Quote attributed to Peter Bernstein.

[vi] For illustrative and discussion purposes only. Reflects hypothetical outcomes for GEM's Endowment Fund Policy, which allocates 53% to equity, 7% to credit, 3% to commodities, 12% to REITs, 15% to Treasuries, and 10% to TIPS.

[vii] Stocks represented by MSCI ACWI Index and Bonds by Bloomberg US Aggregate Bond Index.

[viii] Assumes an information ratio of 0.25. For illustrative and discussion purposes only. Statements regarding forward-looking returns, market events, future events or other similar statements constitute only subjective views, are based upon GEM's current long-term capital market assumptions, expectations and beliefs, should not be relied on as fact, are subject to change due to a variety of factors including fluctuating market conditions, and involve inherent risks and uncertainties, both general and specific, many of which cannot be predicted or quantified and are beyond GEM's control. Future evidence and actual results could differ materially from those set forth in, contemplated by, or underlying these statements. In light of these risks and uncertainties, there can be no assurance that these statements are not or will prove to be accurate or complete in any way.

[ix] Beta based on quarterly returns of the Burgiss Private Equity Universe and MSCI ACWI

[x] Gallagher Re, Reinsurance Market Report, April 7, 2025.

[xi] The Guy Carpenter Rate on Line index is a measure of the change in dollars paid for coverage year on year on a consistent program base

[xii] Source: GEM analysis.

[xiii] Lessons From Steve Mandel - Joys of Compounding Podcast

[xiv] Ed Thorp, A Man for All Markets, 2017

IMPORTANT NOTES

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