Overview

As institutional investors seek ways to improve returns in the current low-yield environment, a number of investment firms are promoting risk parity and risk premia strategies as enhanced solutions. But these strategies don’t present any new insights about investing, nor are they new asset pricing theories that help improve return forecasts. They are essentially portfolio construction techniques that incorporate leverage, short selling and dynamic trading to existing assets.

These strategies are complex to implement. In this report and accompanying video, Wai Lee cautions buyers that it is important to understand the underlying economic rationale in order to assess potential long-term performance.

Practical Applications

• **Better match to investment policy.** Risk parity and risk premia strategies can be more efficient methods to meet stated risk-return goals of pension funds than traditional portfolio allocation. But investors need to grasp the economic rationale for these premia.

• **Use external managers.** Many of these strategies require the use of leverage, short selling, dynamic trading and sophisticated risk management techniques, and they involve complex governance and implementation issues—so it makes sense to use external managers.

• **Proceed with caution.** These strategies may look promising, but will the long-term performance of alternative risk premia persist? Results are still being debated.

Practical Applications Report

Pension funds today are looking for new ways to achieve better risk-adjusted returns in a low-yield environment. Risk parity and risk premia investing have become quite popular, with a number of investment managers touting their diversification benefits. But investors need to take a step back and really understand the sources of these perceived benefits—and limitations—of these strategies, says Wai Lee, CIO and Director of Research at the Quantitative Investment Group of Neuberger Berman.
“Risk parity and risk premia investing help us on the portfolio construction side; they don’t present any new insights about investing, nor do they represent nonreplicable, new investment opportunities,” as some investors seem to think, says Lee. Pension funds should consider using external managers to run risk parity and risk premia strategies—just as they may choose to use hedge funds when they want exposure to long/short strategies, he says.

IN A STRAIGHTJACKET

Many pension funds’ internal investment policies do not permit shorting, leverage or dynamic trading. Both risk parity and risk premia investing typically involve leverage and dynamic trading, and the latter often involves shorting of stocks or other assets.

Impacts of such investment policy restrictions can be quite significant as, combined with 7% to 8% return goals, a number of institutions can end up with a far more concentrated position in stocks regardless of their true investment views, Lee notes. In fact, he points out that the high concentration in stocks may have been the reason for the poor performance of institutional portfolios in the 2008 market crash, rather than the failure of diversification per se, as many market observers have maintained.

So in the current market, do risk parity and risk premia investing provide the improved diversification their proponents tout? The answer, says Lee, is likely yes, but he says that’s because the strategies result in more flexible portfolio construction, not because they are new asset types or new asset pricing theories. Lee explains why in Constraints and Innovations for Pension Investment: The Cases of Risk Parity and Risk Premia Investing, in the Spring 2014 issue of The Journal of Portfolio Management.

IT’S A BETTER RUBIK’S CUBE

To illustrate the benefit of the two strategies, Lee makes a comparison to a Rubik’s Cube. “No matter how we rotate the Rubik’s Cube into different color combinations, it is the same cube. We can, however, make it a better cube by reducing the frictions of rotation,” he explains.

“If an institutional client looks at the research and likes these ideas [of risk parity and risk premia investing], they should know that doing it by themselves can be very challenging,” Lee says. In the article, Lee outlines the next steps for investors: What are the issues to implement? What are the variables to consider?

GET RID OF CONSTRAINTS

Risk parity and risk premia investing are primarily portfolio construction techniques that remove constraints (of leverage, shorting and dynamic trading, among others) in order to achieve better risk and return objectives, says Lee.
At the most basic level, he points to the well-established finding that a constrained efficient frontier of a portfolio is less efficient than an unconstrained efficient frontier, all else being equal. By using the overlay of techniques such as leverage, short selling and dynamic trading, pension funds can improve how they manage—and meet—their risk and return targets.

Pension funds should consider adopting these approaches, despite the considerable implementation challenges of finding the right set of investment skills with the appropriate operational setup, Lee recommends. His employer, Neuberger Berman, offers these strategies to its institutional clients, but rather than discuss the specifics of their approach, Lee says that he adopts a neutral position about the benefits—and pitfalls—of these strategies in his article.

UNDERSTANDING THE BASICS

Institutional investors should first understand that the two strategies are quite different, Lee says. A risk parity portfolio—a long-only portfolio, where each asset is expected to contribute equal risk to the overall portfolio—is typically implemented at the asset class level. In contrast, a risk premia portfolio—where assets are selected based on their exposure to underlying risk factors, such as value, momentum and so on—is typically a long/short portfolio implemented at the individual stock level, or carry premium which is a long/short portfolio of primarily futures contracts.

Lee refers to recent research showing that, historically, a risk parity portfolio is more efficient for the long term than a traditional 60/40 portfolio, which is far more bullish on stocks. The risk parity manager typically uses leverage, through derivatives such as futures contracts, to achieve the return targets while meeting stated risk guidelines. Unlike traditional portfolios that try to keep capital allocation the same over time but allow the risk profile to change, dynamic trading is necessary to maintain the risk parity portfolio’s predetermined risk profile, as risks and correlations of assets change, Lee notes.

The risk premia portfolio is another approach to modeling the matrix of correlated assets, Lee says, noting that it can also provide a more efficient method of meeting risk-return objectives. Examples of more traditional risk premia are equity risk and duration risk premiums, i.e., stock returns and long-term government bond returns over the risk-free rate. Most alternative risk premia portfolios (such as value, carry or momentum) are typically constructed as long/short asset portfolios, he adds.

CHALLENGES PERSIST

Pension funds that want to adopt these strategies need to find the appropriate external manager. Funds should ensure the manager provides dedicated operational support, including trading, counterparty risk management, and ongoing performance measurement and governance, in addition to the essential investment skills for success.
Beyond that, Lee outlines a number of significant issues being debated among investors, managers and consultants:

- The much-discussed low correlation of these alternative risk premia to traditional assets should be expected, because they are long/short portfolios, Lee says. But key questions persist: “Do these alternative risk premia make economic sense? Are you really convinced these risk premia will persist going forward? And how much of these premia should or can you have?” As this strategy gets more popular, correlations among the constituent components may trend higher, increase their volatility and depress their future risk-adjusted returns.

- Unlike traditional risk premia such as equity, which is a truly passive strategy that every investor can follow, not everyone can invest in alternative risk premia (because they take long/short positions). “So if we are convinced [of their potential outperformance], then who will be willing to take on the other side of the trade and provide the premia for others to earn?” asks Lee.

- Implementing the strategy involves choices about management. Should a pension fund pick a single external manager to manage multiple risk premia, or should it choose multiple managers, each with expertise in different risk premia—and pay higher implementation costs?

“More institutional clients today recognize that these are all issues to be aware of,” Lee says. “The good news is there is more research to support why alternative risk premia make sense and why they will persist in the future,” he says, adding that he continues to monitor research by the naysayers.

To order reprints of this report, please contact Dewey Palmieri at dpalmieri@iijournals.com or 212-224-3675.