

# Overexposed to U.S. Large Caps? Let Simple Math Guide the Rebalance

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The steady, upward trajectory of U.S. large-cap equities over the past decade has left many portfolios overexposed to the asset class. But rebalancing presents a conundrum: How can advisors decrease allocations to one of equity markets' least-risky segments—and capitalize on more attractive valuations elsewhere—without upsetting a portfolio's overall risk profile?

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It comes down to risk budgeting. The topic is typically the purview of dense whitepapers, but a back-of-the-envelope calculation shows how risk budgeting works and illustrates the challenge in front of advisors. It also shows the understated role alternatives can play in bringing portfolio risk back in balance.

## The Simple Math Behind an Opportunistic Tradeoff

To illustrate risk budgeting and the interplay between the assets an investor holds and wants to add, consider a client's equity allocation. For example, if the equity sleeve is purely U.S. large-cap equities, it has a projected volatility of 16%, or for a simple calculation, 16 risk units. Now, let's assume an investor wants to take advantage of attractive equity valuations in emerging market equities and allocates a quarter of the equity sleeve accordingly.

With a projected volatility of 24%, or 24 risk units, emerging market equities carry considerably more risk than U.S. stocks. Adding the 25% allocation assumes six risk units for the emerging markets allocation (i.e., 24 risk units x 0.25) and 12 risk units for the U.S. large-cap equity portion (i.e., 16 risk units x 0.75).

In this example, the client's equity allocation now carries 18 risk units, far greater than its initial 16. The portfolio's return potential may have been boosted by adding emerging market equity, but so too, has the portfolio's risk.

The challenge is to bring the client's portfolio back to its original risk level, without sacrificing the return potential they sought to improve.

## KEY TAKEAWAYS

- Advisors are challenged to decrease U.S. large-cap equity allocations and capitalize on more attractive valuations without upsetting a portfolio's overall risk profile.
- Risk budgeting shows the understated role alternatives can play in bringing portfolio risk back in balance.
- While some alternatives diversify a portfolio, the biggest benefit of others is to improve risk-adjusted returns.

Some alternatives can diversify a portfolio, while others improve risk-adjusted returns

## The Balancing Act: Maintaining Overall Risk Without Sacrificing Returns

When adding a new, riskier asset class to the portfolio, investors can always offset the risk by subsequently increasing their fixed income allocation. In the previous example, we focused only on the equity sleeve of a portfolio. One could add emerging market equities to the portfolio, decrease the U.S. equity allocation further and increase the portfolio's allocation to bonds. This is a tenuous balancing act however: the lower return profile of bonds dilutes the return potential the investor just gained by adding emerging market equities.

The conundrum illustrates how alternatives can help a portfolio, if clients understand their role. While some alternatives diversify a portfolio, the biggest benefit of other alternative strategies is to improve risk-adjusted returns. This is the case for two alternatives, long/short equity and managed futures. Both could have similar return profiles to U.S. equity going forward but achieve those returns with less volatility.

For example, long/short equity has a historical and projected volatility of 8% (eight risk units), far below the 16% for U.S. large caps. But the expected return for long/short equity funds is 4%, not far from the 4.5% return assumption experts predict for U.S. large-caps.<sup>1</sup>

Borrowing from the earlier example, if the advisor wanted to take advantage of an emerging markets selloff, they could create a 25% allocation to emerging markets (again, a cost of six risk units) and reduce large cap equity exposure to 50%, a cost of eight risk units (i.e.,  $16 \times 0.50$ ). To bring risk into balance, they could allocate 25% of the equity sleeve to long/short equity, a cost of just two risk units (i.e.,  $8 \times 0.25$ ). The equity sleeve totals 16 risk units, just like the original sleeve of 100% U.S. large-caps, but the portfolio gained the excess return potential of emerging market equities.

As the example illustrates, alternatives can play an understated role in managing total portfolio risk. Advisors should keep them in mind as they rebalance portfolios to reduce U.S. large-cap exposure.

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## About 361 Capital

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<sup>1</sup> Source: BlackRock capital market assumptions as of December 2019.

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