Risk Budgeting Using Alternatives

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The return of volatility has brought opportunity. The steady, upward trajectory of most markets in recent years provided few opportunities to tactically increase allocations to an oversold asset class. That backdrop finally may be changing.

The recent selloff has advisors and clients discussing how to nimbly take advantage if another correction looms. Before eyeing that entry point into a riskier asset class, however, advisors face a conundrum: How can they add a riskier — albeit attractively valued — asset class without upsetting the portfolio's long-term risk profile?

KEY TAKEAWAYS

- It comes down to risk budgeting. The challenge is to bring the client's portfolio back to its original risk level without sacrificing the return potential they sought to improve.
- When adding a new, riskier asset class to the portfolio, investors always can offset the risk by subsequently increasing their fixed income allocation.
- Advisors should keep alternatives in mind when volatility presents another opportunity.

It comes down to risk budgeting. The topic typically is 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.

Math Behind Tradeoff

To illustrate risk budgeting and the interplay between the assets an investor holds and wants to add, consider a client's equity allocation. 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 an emerging market's selloff 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 (24 risk units x 0.25) and 12 risk units for the U.S. large-cap equity portion (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.

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Balancing Act

When adding a new, riskier asset class to the portfolio, investors always can offset the risk by subsequently increasing their fixed income allocation. In the example above, 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: The lower return profile of bonds dilutes the return potential the investor just gained by adding emerging market equities.

The conundrum illustrates how alternatives help a portfolio, if clients understand their role. While some alternatives diversify a portfolio, the biggest benefit for others 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 funds is 4%, not far from the 4.5% return assumption BlackRock forecasted in December 2019 for U.S. large-caps.

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 (16 x 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 (8 x 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, some alternatives play an understated role in helping investors be dynamic. Advisors should keep them in mind when volatility presents another opportunity.

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About 361 Capital

361 Capital is a leading boutique asset manager focused on alternative and behavioral-based equity solutions that seek to deliver meaningful alpha, manage risk and offer diversification potential to investor portfolios. Founded in 2001, we offer a suite of investment products including Long/Short Equity and Managed Futures, as well as Small, Mid and Large Cap Equity.

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361 Capital | 4600 South Syracuse Street, Suite 500, Denver, CO 80237 | 866.361.1720 | 361capital.com | Follow us: