Alternative Investing

Risk Parity: A Supplement to Traditional Portfolios, Not Their Replacement

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It is often said that long-term investors can rely on equity returns since they can withstand short-term periods of underperformance and still survive to realize the benefits in the long-term. In this article, the authors contend that in the past 40 years stocks have had no better risk-adjusted returns than bonds or commodities (and if you study the narrower, but longer data histories since the 1920s, risk-adjusted returns on equities actually have been slightly lower than bonds).

Regardless of whether or not an investor believes they have a long or short investment horizon, this empirical observation leads to a surprising fact: not only would a risk-diversified portfolio managed to similar risk levels have had more muted drawdowns than the traditional, equity-dominated portfolio, it also would have had higher returns. That is, despite the conventional wisdom, in the long run an equity-oriented portfolio did not deliver the highest returns, and certainly not the highest risk-adjusted returns.

The benefits of risk parity should not, however, be oversold. As we have demonstrated, Sharpe Ratios of risk parity portfolios should be a bit higher than that of traditional allocations, but investors should not expect steadily higher returns.

The authors write that risk parity is not a “silver bullet,” but say they believe that within the larger context of a traditional allocation, it is a useful strategy that raises portfolio risk-adjusted return while reducing concentration in equities.

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