



ALTERNATIVE INVESTING

Understanding Risk Parity

October 1, 2010

AQR White Paper

Traditional investment portfolios often give the illusion of diversification when in fact they have concentrated exposure to the equity markets.

Why? Because portfolio allocations to equities are typically 60% or higher (think of the traditional 60/40 portfolio: 60% of its assets in equity, 40% in fixed-income). Since equities have about three to four times the risk of bonds, this allocation leads to a portfolio allocating roughly 90% of its risk budget to equities. In other words, when viewed through the lens of risk, traditional asset allocations are highly concentrated in the equity markets — and not actually diversified at all. The concentration of traditional portfolios can lead to less-consistent performance across economic scenarios, and higher tail risk.

Risk Parity portfolios rely on risk-based diversification, seeking to generate returns that are both higher and more consistent. A typical Risk Parity portfolio begins with a much lower exposure to equities relative to traditional portfolios, and invests significantly more in other asset classes. As a result, the risk budget of the portfolio is not concentrated in equities, but spread more evenly across other asset classes. The key to Risk Parity is to diversify across asset classes that behave differently in various economic scenarios. In general, equities do well in high-growth and low-inflation environments; bonds do well in deflationary or recessionary environments; and commodities tend to perform best during inflationary environments. Having balanced exposure to these three main asset classes may produce more consistent long-term results.

The paper describes a Simple Risk Parity Strategy and demonstrates how it consistently outperforms the typical 60/40 portfolio over nearly 40 years of historical data.

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