

Alternative Investing

Risk Parity, Risk Management and the Real World

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AQR White Paper

At the heart of risk parity, there is risk management.

Risk parity's core benefit — improved portfolio diversification — ultimately is a product of how well risk is assessed and managed. For investment managers, the practical considerations are important.

Risk parity strategies share two common elements: (1) balanced risk exposures, which usually mean less capital exposure to stocks than traditional portfolios (and more exposure to everything else); and (2) the use of leverage to scale the portfolio risk to about the level of traditional portfolios.

The goal of risk parity strategies is for everything in the portfolio to matter, but for nothing to matter too much. Implicit is the assumption that risk parity managers can make reasonable assessments of risk, and make those assessments in a constantly changing market environment.

In this paper, we conclude that risk parity portfolios require dynamic management; their holdings need to be regularly adjusted to reflect the dynamics of underlying market risk. Further, we conclude that risk parity portfolios should incorporate a planned capital-preservation strategy to try to avoid significant disruptions in a crisis.

At its core, risk parity is an argument about the importance of diversification — across time and across asset classes. In the long term, we think the best risk parity portfolios will be those that both adopt a dynamic approach to risk management and have a plan to preserve capital in a crisis.

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