

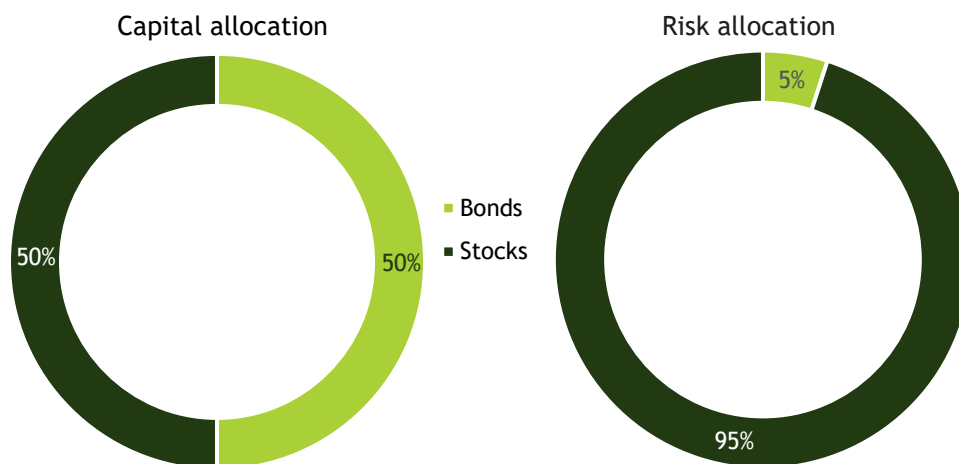
What is risk parity?



Investors are typically counseled to diversify capital across asset classes to reduce risk. Considering this, it may be a surprise to learn how concentrated the risk sources of a traditionally diversified portfolio may be.

Risk parity is an investment strategy that seeks to balance the sources of risk in a portfolio. The easiest way to envision this concept may be to consider it in the context of a traditional, diversified portfolio. For many investors, this portfolio is represented by defined percentage allocations across stocks and bonds. Such a balanced portfolio, for example, may allocate 50% of its assets to stocks and 50% to bonds in an effort to achieve diversification. However, the theory of risk parity indicates that this equal allocation of investment capital does not necessarily equate to being diversified by risk. This is because stocks tend to exhibit four-to-five times more volatility than bonds. So, while the weighting of a balanced portfolio appears to be adequately diversified, the investment in equities carries significantly greater risk than the investment in bonds. Exhibit 1 highlights the disparity.

Exhibit 1: Balanced portfolio allocations

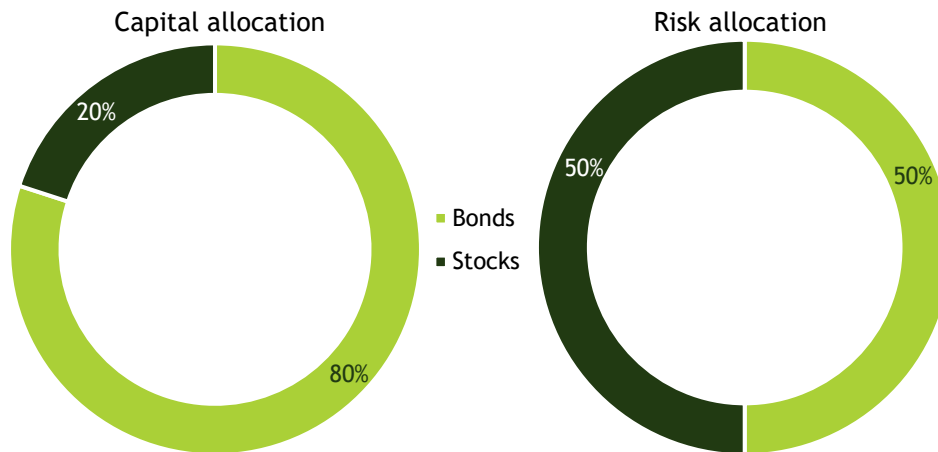


For illustrative purposes only.

Risk parity: Balanced risk

Risk parity investment strategies seek to diversify sources of risk. Each source of risk carries a risk premium, which is a potential source of return. To achieve this diversification, these strategies assume that asset classes (such as stocks and bonds) should contribute equally to the level of risk in a portfolio. As shown in Exhibit 2, given the different historical volatility of stocks and bonds, to achieve a balanced risk contribution between the two assets classes, the allocation to bonds must be much larger than that of stocks.

Exhibit 2: Different view when balancing risk



For illustrative purposes only.

Risk parity: Beyond the basics

At the simplest level, a risk parity portfolio seeks to achieve equal contributions to risk across various asset classes. In addition, risk parity strategies tend to allocate beyond stocks and bonds in an effort to provide upside growth and downside mitigation through various economic scenarios.

For example, a hypothetical risk parity strategy may include global stocks, in addition to domestic stocks for growth-oriented environments and inflation-sensitive assets (for example, commodities) for inflationary environments. These assets are not always accounted for in less-diversified portfolios.

Once the asset-class allocations are established, some managers maintain equal contribution to risk by monitoring a short-term level of volatility of each asset-class bucket and actively rebalancing the portfolio's exposure based on rising or falling volatility. When the volatility of an asset rises, its contribution to risk is maintained by reducing its allocation to the portfolio. If all assets experience an increase in volatility (as in the Global Financial Crisis or the COVID-19 pandemic), exposures across each bucket will be reduced and the assets shifted to cash.

Potential benefits

Proponents of risk parity believe that a balanced risk allocation can produce more consistent returns than a traditional capital-allocated portfolio over time. The benefits of the strategy include reduced allocations to and reliance on the stock market generally, a more diversified set of exposures during varying economic scenarios and the potential for enhanced risk/return characteristics.

Risks

No investment strategy is without risk. Seeking to allocate assets in a way that keeps one asset class from dominating performance can be beneficial for risk-management purposes. However, portfolios genuinely diversified by risk can experience large performance differentials (both positive and negative) relative to more traditional portfolios "balanced" by capital allocation. Though we fully expect diversified portfolios to outperform those that are concentrated, these expectations may not be realized over any given finite period.

While allocating more dollars to lower-volatility asset classes would seem to reduce both the expected risk and the expected return profiles of a portfolio, risk parity managers typically address this by targeting a level of volatility similar to that of a more traditional portfolio. This is generally accomplished by applying a modest amount of leverage to a diversified portfolio of asset classes. By targeting a similar level of risk in a more diversified fashion, risk parity seeks to outperform traditional portfolios via extra-efficient portfolio construction.

Important information

Information provided by SEI Investments Management Corporation (SIMC). This information should not be relied upon by the reader as research or investment advice and is for education purposes only and

Investing involves risk, including possible loss of principal. Bonds are subject to interest rate risk and will decline in value as interest rates rise.

Diversification does not ensure a profit or guarantee against a loss.