How adaptive risk allocation works

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So there's two types of allocation. There's capital allocation, and there's risk allocation. Capital allocation says if have $100, maybe I'll put $50 into stocks and I'll put $50 into bonds. If you have risk allocation then what you're saying is you want to take maybe 50% of your risk in stocks and 50% of your risk in bonds. And those two ideas, capital allocation and risk allocation, are very different. If you put $50 in stocks and $50 in bonds, then 90% of your portfolio risk is going to be coming from the stocks.

To do risk allocation, you might have $25 in stocks, $75 in bonds, and that's a way to ensure that you have a better balance of risk within your portfolio.

The idea is that by having your risk balanced, then you're going to be able to have a portfolio which is robust, regardless of what happens in the market. If you have a $100 portfolio with $50 in stocks and you have $50 in bonds, your portfolio will still really live or die by the stocks that are in that portfolio, as opposed to the bonds. So risk allocation will ideally give you a more diversified outcome.

One of the aspects of risk allocation which is challenging for advisors is leverage. To be able to achieve a similar outcome as an equity-heavy portfolio, you need to take leverage in addition to balancing your risk across different asset classes.

When someone expresses concerns about leverage, we try to assure them that we're using leverage responsibly. We're not necessarily taking 10 times leverage, 15 times leverage, 20 times leverage, the sort of thing which might happen at a hedge fund, for example. We take 1.5 times leverage, We believe that that sort of leverage, in a measured amount, when used responsibly, can really help the portfolio outcomes.

Adaptive risk allocation

Static risk allocation keeps the same portfolio all the time, regardless of what the environment is. And the reality is that even if risk allocation is a good idea over the long time, there are certain times where you might want to have more of your risk in equities, less of your risk in equities, maybe you want to take more leverage overall, maybe you want to take less leverage to protect against things that are going wrong. So if we can identify different times of the market where it would be a good idea to move away from a static portfolio and to adapt to the different environment, we believe that that will provide an even better outcome.

Our adaptive market state classification system, believes that there are four states of the world. Most of the time, we're in what we call the neutral state. It's a state where we really see similar risk-adjusted returns across many asset classes. Two-thirds of the time we're in that state, that's an area where we believe the traditional static-risk allocation is a very good idea. However, we also believe that we can identify other states of the market where we might want to deviate from that approach.

The first one that I'll talk about is the bullish market state. The bullish market state is where we feel that things are actually going a little bit better than usual for world markets. That means that you want to take a little bit more of your risk in equities, you want to take a little bit more of your risk in credit markets and inflation theme markets, and you want to take a little bit more leverage overall. That's what we believe will be the right allocations for the bullish market state.

The other two states that we have are even rarer. One of them is the highly bullish state, which we only identify less than 5% of the time, over our historical simulations. And that's a time where you really meaningfully want to move away from rate risk, and you want to move towards equity risk.

And finally, one of the most important states that we identify is called the "capital preservation state." That's a state where we do believe that there are some challenges for the markets. That's a state where we want to meaningfully move away from equity risk. That's a state where we want to de- lever the portfolio overall, so that we're taking less risks in markets altogether.

An important point is that's a tactical view. So even in the scheme of a very long market, where we might believe that equities are a good idea, we might have one or two months that are capital preservation. It doesn't mean that we don't believe that stocks are a good idea for the long run, it just means that in those particular months, we thought that investors should be exercising caution.

Mitigating portfolio draw-downs

So a 60-40 portfolio will definitely control your portfolio draw-down more than 100% equity portfolio. We believe that a static risk allocation portfolio will be better at draw-down control than a regular capital allocation balanced portfolio. And we definitely believe that the adaptive risk allocation approach, by identifying the capital preservation state, can avoid drawdowns more than any static risk allocation approach.

A “drawdown” refers to a decline in the value of an investment or portfolio.

“Leverage” refers to market exposure in excess of assets.