FIRST QUADRANT

FQ INSIGHT:

The Right Asset for the Right Job

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ED PETERS
Partner, Investments

Risk Parity has been described as "loving all your children equally." While we agree with the sentiment regarding children, we disagree with respect to the assets within Essential Beta (EB). We think of the assets as employees rather than our children since each asset is included in the portfolio to do a job. Those functions are necessary for the portfolio to achieve its investment objectives. Given that we recently "fired" the German Bund from the portfolio, we thought it might be useful to reiterate the duties that each asset has in achieving those investment objectives. This function-based approach also illustrates why we do not believe that a risk parity allocation is appropriate at all phases of the business cycle.

EB's investment objective is to give an equity-like return at lower risk and a low correlation to equities. Namely, EB's return objective is either "Cash + 5%" or "Inflation + 6%", each constituting the equity risk premium over a risk-free rate over the long-term horizon. EB is designed to achieve this goal by participating in global economic growth while hedging against both global economic decline as well as asset value erosion from inflation and deflation. There are three groups of assets, each chosen to contribute an important attribute towards constructing the well-balanced total portfolio.

The primary portfolio drivers are assets which participate in real economic growth. These assets are connected to various aspects of the global economy and benefit when the economy is expanding. Equities remain the principal growth assets and include large cap developed market equities, small cap equities, emerging markets, and property in the form of Real Estate Investment Trusts (REITs). Corporate bonds (both high yield and investment grade) also have an equity component and so grow with the world economy.

However, inflation can erode asset values; so in a multi-asset diversified growth portfolio, it is important to also have an inflation hedging component. EB uses a basket of commodities for this purpose. Since inflation can take multiple forms, we need different types of commodities in the portfolio. To hedge against economic inflation, we use energy-related commodities and industrial metals. We include grains, softs, and livestock exposure as protection against food inflation. For monetary inflation, we have precious metals, which also serve as an "uncertainty" hedge. In addition to commodities, REITs also serve an inflation-hedging function. Real estate is a physical asset, so REITs have been shown to be an effective inflation hedge. Finally, inflation-linked bonds (linkers or "TIPS"), have an inflation hedging component for the fixed income market.

The portfolio also requires protection against the deflationary forces that accompany economic slowdowns and recessions. Sovereign bonds serve three distinct functions, and so are like journey men in the portfolio. Their job largely depends upon where we are in the market

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

cycle. High quality sovereign bonds are the best defender against deflation. Due to their flight-to-quality characteristics, sovereign bonds are also an effective proxy hedge for risk assets, such as equities and corporate bonds, especially during bear markets. Lastly, they are effective diversifiers, having a low correlation to both stocks and commodities. In addition to sovereign bonds, EB also uses equity options to hedge against downside risk when bonds are vulnerable to inflation risk. TIPS also benefit from flight-to-quality trades.

Each asset has a job to do, but not all are appropriate at all phases of the business cycle. Just as you would not send an accountant to fix a furnace, you would not depend upon sovereign bonds to hedge against inflation. The FQ Market Risk Index (MRI) gives us an indication of which type of risk we currently face, and allows EB to determine which assets are likely to do the best job at mitigating this risk. Sometimes, an asset may no longer be up to the task, so it must be temporarily removed from the portfolio. German sovereign bonds recently fell into this category. We remain in a resilient market environment tied to global economic growth. At this phase of the cycle, sovereign bonds are not held for return, but for diversification and downside protection. That is their job. But with the 10-year Bund yield dropping to less than 10 basis points[1] in April, it was questionable whether the Bund could do its job. It might be able to, just as a football player with a sprained ankle might still be able to perform. But why take the chance when there are other players in whom we have more confidence? As a result, we moved the normal Bund risk allocation to US Treasuries and UK Gilts, which we believe are more able, due to their higher yields, to provide downside protection in addition to diversification. Bunds were temporarily moved to the sidelines.

This function-based approach also explains why EB is not leveraged bonds at this stage of the business cycle. Leveraging bonds is necessary for deflation and tail-risk hedging during economic declines, but options are better suited to provide downside protection than bonds in a growth environment. So we give options the primary responsibility for tail-risk hedging and reduce dependence on bonds, which now have an inflation risk. It is all a matter of finding the best asset for the job we need done.

Eventually the German Bund will return to yield levels where it can once more serve its function in the portfolio. For now, however, we are more confident there are other assets which can do the job better.

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Endnotes

[1]Bloomberg LP

FIRST QUADRANT, L.P. | 800 E. COLORADO BLVD. SUITE 900, PASADENA, CALIFORNIA 91101
MARKETING SERVICES INFO@FIRSTQUADRANT.COM | OFFICE 626 683 4223 | WEB FIRSTQUADRANT.COM