

**ON A FORWARD LOOKING BASIS RISK PARITY LOOKS RISKY**

**BACKGROUND**

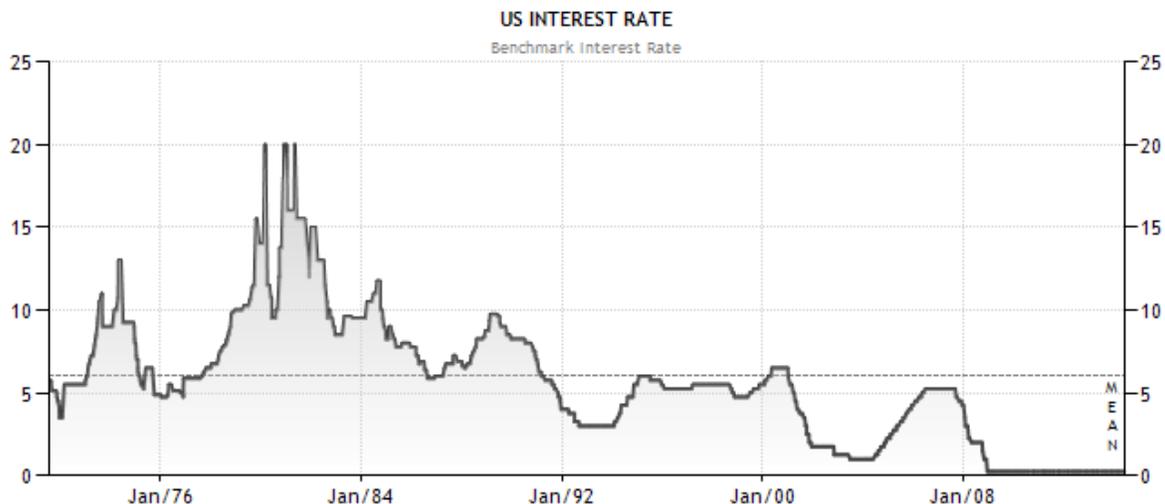
Risk parity strategies attempt to balance risk and reduce portfolio volatility through the strategic use of leverage. The concept seeks to balance risk exposures more evenly than in a typical institutional portfolio; in particular by reducing a portfolio’s typical overweight to equities and increasing exposure to other assets, such as fixed income. Risk parity through the use of leverage, attempts to increase effective exposure to lower volatility assets classes and to achieve a desired overall expected portfolio return.

Most institutional investors have allocated the majority of their portfolio to equities and other return generating assets. The portfolio’s volatility is thus dependent upon the allocation to return generating assets, with other parts of the portfolio making a lower contribution to return. In the traditional sense, an institutional portfolio would normally be 60%/40% allocated between equities and fixed income.

Under Risk Parity, portfolio assets are allocated in a manner where equity and debt equally contribute to the total portfolio’s volatility. The historical volatility levels of equities and bonds, as measured by annual standard deviation, average approximately 18% for equities and 8% for fixed income. To equalize the contribution of fixed income to portfolio risk, these assets are levered as much as 2 to 1 or greater.

**THE RISK OF LOOKING BACKWARD**

In theory “Risk Parity” portfolio concepts sound reasonable. However, return expectations and correlations may change given the low interest rate and tight credit spread environment which negatively impacts the fixed-income component and risk from leverage. A historical look at interest rates is important in gauging the “future” prospects for risk parity. The chart below shows the US Benchmark Fed Funds rate, which has averaged approximately 5% from 1970 to the present. Since the average rate has been decreasing steadily over this time, backward-looking models such as those used for Risk Parity favor bonds over other asset classes.



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As fixed income rates have continued to decline since 1980, bond prices have increased - a price trend that cannot be replicated in the present and future environment.

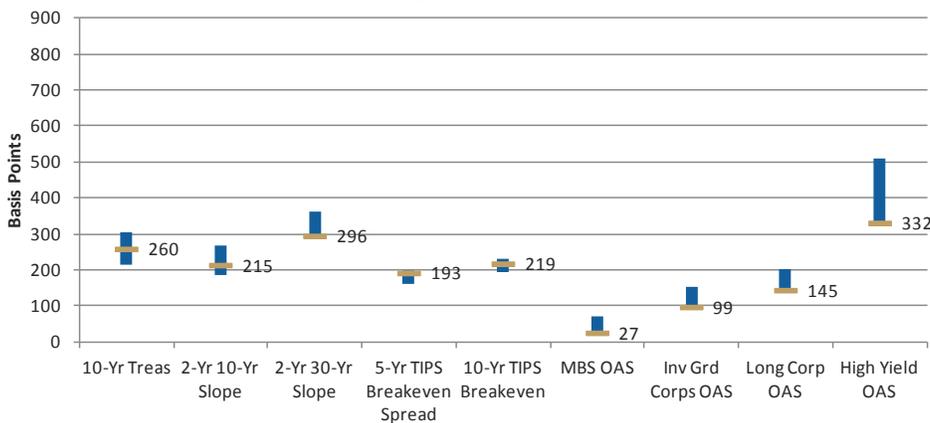
Low absolute yields and lower volatility create a recipe for higher leverage in portfolios trying to achieve the same return, such as risk parity. The table on the right shows how the anticipated rise in interest rates due to Fed Tapering and the potential of higher U.S. GDP growth can negatively affect bond prices. With the current 10 year Treasury rate at 2.61%, the table shows that a 1% increase in rates will cause an estimated loss to principal of -8.30%. A 2% rise in interest rates can lead to a loss of -15.9%. **These potential losses would be magnified within the risk parity investment approach.** As previously discussed, the use of leverage on an estimated 2 to 1 basis **would double the loss from bonds to over -30%** during a 2% rise in interest rates. The probability of such an occurrence has been amplified by the fact that the average 10-year Treasury yield from 1980 to the end of 2013 is 6.67%. Thus even a 50% retracement of rates to a historically normalized level could lead to a rise of interest rates in excess of 2%.

In reviewing other fixed income alternatives, the search for yield has also made every investment grade and high yield fixed-income sector expensive. The table below illustrates how it would be challenging to produce enough return to produce the 5% long-term requirement of many educational institutions.

Effect of Yield on Bond Price		
Price change from the current yield	10yr Treasury	Estimated Price Change
	+2%	-15.9%
	+1%	-8.3%
	2.61%	0%
	-1%	9.2%
Price change from a 6% yield level	10yr Treasury	Estimated Price Change
	+2%	-13.6%
	+1%	-7.1%
	6.00%	0%
	-1%	7.8%
Price change from an 8% level	10yr Treasury	Estimated Price Change
	+2%	-12.5%
	+1%	-6.5%
	8.00%	0%
	-1%	7.1%
	-2%	14.9%

### 52-Week Highs, Lows, and Current Levels

As of 6/13/2014



For investors concerned about maintaining purchasing power, Risk Parity does not hedge inflation well because of the higher allocation to “lower volatility” asset classes that are negatively impacted by inflation such as bonds.

### CONCLUSION

**Risk Parity strategies are not recommended in the current environment where interest rates are expected to rise.** During 2005-2006, when historically low volatility and low interest rate spreads persisted for many quarters, the financial markets used more and more leverage to create higher returns, which directly contributed to the financial crisis. Investors today are faced with a similar “statistically low volatility and return” environment, where the sizing of investments are enhanced via the use of leverage in order to reach desired levels of return. The present environment where muted returns are being leveraged through the implementation of strategies such as Risk Parity, can lead to dramatic underperformance due to the interest rate and duration risk present in the market. Clearbrook has implemented alternatives to the Risk Parity approach for a number of our clients to achieve their investment objectives. We welcome inquiries regarding these preferred investment solutions.