# Smart Diversification

The strategic allocation problem for institutional investors has traditionally been one of allocating long-only dollars to growth assets, typically in the form of equities and more defensive income assets – typically bonds. Diversification in that space has been achieved by looking across regions, or investing across the risk spectrum in similar assets. The problem in these so-called balanced portfolios is that in a 60% allocation to equities, for instance, paired with a 40% allocation to bonds, the risk in that portfolio is about 95% attributable to equities.

One approach that's become popular over the last few years to help get away from this concentration and equity risk is a risk parity allocation. This is where you will allocate to asset classes not on a long-only dollars basis, but on a risk basis. And to get a similar level of risk with an asset class like bonds as you have in equity, that will typically mean using leverage. Over the last several years, these strategies have performed fairly well, as you've had rising equity markets and falling interest rates until fairly recently. The challenge looking forward is that we are starting from a point here with fairly rich equity valuations, as well as very low bond yield.

We think given the challenging return environment that we're facing, there's actually a smarter way to diversity the portfolio. This smarter way includes investing in absolute return strategies. Absolute return strategies go long where there are attractive opportunities across the capital markets, and go short, or sell, unattractive opportunities. By doing so, we can design a portfolio that's naturally diversified away from traditional sources of risk. This is a much smarter way, and a direct way, of diversifying the portfolio.

Systematic absolute return strategies tend to benefit from two sources of return. One is behavioral mispricing, as a lot of investors exhibit overreaction or underreaction, that's a source of return for systematic investors. Secondly, these strategies benefit from risks that are not widely shared in the capital markets. These are economic risks that the portfolio takes on. By capitalizing on behavioral biases, and not generally accessible sources of risk, such as currency carry, these strategies actually diversify the sources of return of the portfolio away from traditional asset class into new and more market neutral opportunities.

Absolute return strategies can take a variety of forms. One example of absolute return strategies is the relative value market neutral type of strategies. These types of strategies invest in highly liquid instruments across a variety of asset classes – country equities, bonds, currency, commodities – in both developed and emerging markets. Absolute return strategies can also be structured as directional strategies. These strategies are meant to be market neutral over a full market cycle, but at points in time they might be net long or short across different asset classes. Given the complementarity in different types of characteristics in relative value and directional, for a given risk budget they can be combined in a very capital efficient way to generate an attractive risk return payout, with minimum correlation toward traditional asset classes. When we talk about absolute return strategies, risk budgeting is critical.

Traditional asset classes come with natural volatility. There's a certain volatility associated with stocks, or bonds, and so forth. When you allocate to absolute return strategies, you have to decide how much risk you want to allocate to these strategies.

We actually believe that risk budgeting is an active investment decision. And in order to do that, an investor should think about: skill, leverage, and then breadth. Everything else being equal, an investor should allocate more of his risk budget towards strategies where he believes he has higher scale, towards strategies that require less leverage, or that are more capital efficient. And finally, towards strategy where he has more bets or higher breadth.