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Risk parity's new future

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Note to managers: The passive revolution that has decimated stock-pickers and completely upended the fee structure of most of the industry is now coming to less traditional corners of the global financial markets.

Where exactly? Risk parity might be next.

Ever since Bridgewater launched the pioneering All Weather Fund in 1996, investors have turned to the strategy for the kind of downside protection traditional asset allocations have not been able to provide.

The Great Recession a decade ago solidified risk parity's credentials, but as the memory of the crisis wanes, many asset allocators find – in this brave new world of cost-consciousness – its hedge-fund price too damn high to justify.

Even low-cost, mutual fund versions of the strategy face significant pushback from investors for their asking fees.

When Wealthfront, the robo-advisory start-up, introduced a risk-parity mutual fund last February it couldn't anticipate that only two months later it would have to halve the fund's expense ratio following heavy criticism from investors on social media.

The CEO of the Redwood City, California-based firm, Andy Rachleff, argued then the original 50bps fee of the risk parity fund caught investors, who were used to lower prices of index-tracking ETFs, the vast majority of the products Wealthfront offers, off guard.

But after the robo-adviser cut down the fee to 25bps, Rachleff also said that his firm has always aspired to imitate Vanguard, which revolutionised asset management pricing by slashing expense ratios "as their products scale".

What is changing is the increased focus on fees and transparency. People are not willing to pay the price of active managers

For retail investors, the Wealthfront fund might make sense. At the time of fee reductions, it had already amassed $500m, although its rapid growth can be attributed to the automatic selection of the fund by Wealthfront's algorithm.

For institutional investors looking to produce wholesome risk-parity portfolios, however, a single mutual fund might not be the best option. Still, it seems likely that Rachleff's Vanguard-like scaling could resonate with allocators if such an option was available.

The problem was – and has always been – that with more complex, non-traditional strategies a passive approach is particularly hard, especially if there is no benchmark to track in the first place.

Enter indices providers MSR and S&P Dow Jones. The two firms joined forces to create what they describe as the first rule-based, fully transparent and liquid – thus investable – index family designed to replicate a multi-asset risk parity strategy using futures.

"We have created an index for a very large market that didn't have one," says Michael Rulle, founder and CEO of MSR.

The claim of the benchmark's uniqueness might not sit well with other financial firms maintaining that they first solved this problem.

Salient Partners, the Houston-based asset manager, was the original claimant of the space. HFR, the Chicago-based hedge fund research group, rolled out its own family of risk-parity indices, co-developed with the $91.2bn Ohio Public Employees Retirement System, in August 2017.

But according to MSR and S&P, the big difference between those benchmarks and the S&P Risk Parity Indices, the brand name of the family, is that the former are effectively composites of how various managers in the space are performing, while the latter replicates the actual strategy – the way it is being executed by risk-parity managers.

An HFR representative declined to comment on the S&P/MSR risk parity index but said: "It is accurate to say that HFR's risk parity indices are indices of managers in the risk parity space."

"A composite benchmark is like a black box, you don't know what's in the index," adds Vinit Srivastava, a managing director at S&P who worked on the project with MSR. "We wanted to create an investable benchmark… here investors know what they are getting."

For that reason, when Jodie Gunzberg, then head of commodities at the index giant and now S&P's US equities head, began looking for a partner to assist in the construction of a benchmark that would add to its growing family of quantitative and event-driven indices, finding a firm with "manager experience" in the CTA space was "top priority", says Srivastava.

MSR was a natural fit. Founded in 2008 as MSR Investments by former Graham Capital president Rulle, the firm was a CTA for the first six years of its life. Then in attempt to diversify its business, the firm decided to break into indexing with its proprietary technology platform, for which it spent upwards of $5m to develop.

According to MSR, the platform, a library of thousands of indices and algorithmic models, allows investors who want a liquid alternative to investing with CTAs, hedge funds and traditional long-only managers to create their own custom portfolios and indices, incorporating multiple investment styles, market sectors, and risk management tools seamlessly.

"We are now 100% in the index business," says MSR COO Matthew Brown, who has worked for close to two decades with Rulle. He was hired by Rulle in 1999 to manage the fixed income arbitrage team at hedge fund Hamilton Partners, where Rulle was president and CIO at the time.

"We built a research platform that ended up being a library of algorithms," Brown adds. "The platform was really impressive, and we were trying to think what to do with it."

Hence, MSR Indices, a separate firm but staffed with the same people as MSR Investments, was created in November 2014.

The initial discussion between S&P and MSR for the risk parity indices took place in the summer of 2016 and the work began in the autumn that year. It took a year to design the index and then another six months of quality control testing before launch this August.

MSR had to customise its algorithms for S&P and also add some markets it didn't already include in its platform as S&P requested.

"We needed someone who had managed money [in risk parity] and knew the decisions these managers have to make," says Srivastava.

"Algorithms can be developed by everyone. But we needed to know about the rebalancing process; we needed someone to tell us if the [futures] contracts are liquid enough… The principles at MSR have been around in the space for decades and knew it very well as a CTA."

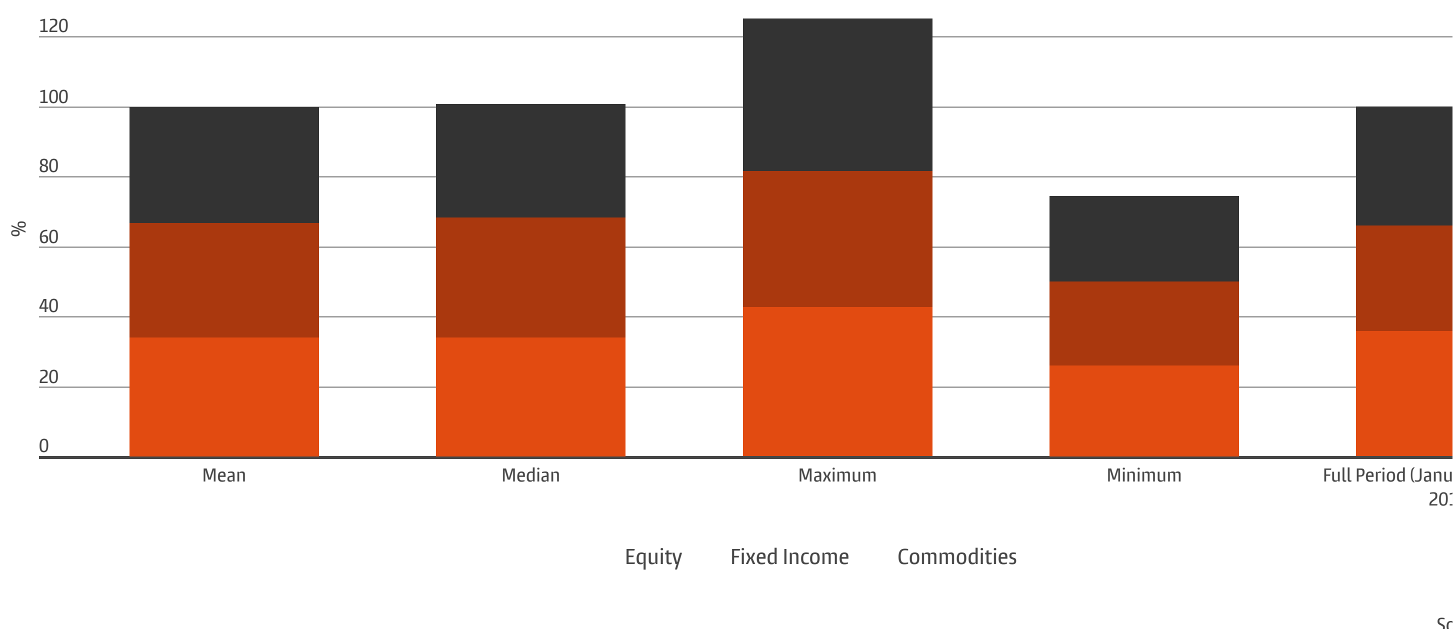
S&P also reached out to institutional clients to ask for the input.

"We worked very collaboratively with clients who run money and have credibility in the space," Srivastava says.

The end result was three indices that target different levels of volatility – 10%, 12% and 15% – in line with what the market gets from active managers in risk parity.

The underlying portfolio of the benchmark consists of futures contracts from the three most liquid asset classes: equity, fixed income and commodities.

Annual risk allocation by asset class for the S&P Risk Parity Index – 10% target volatility



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For each futures contract used, S&P has applied a minimum annual total dollar value traded of $5bn to ensure replicability and tradability.

To measure risk but avoid dependence on volatility forecasting models, the creators of the indices used realised rather than forecast volatility in their calculations. They back-tested those results starting from a minimum of a five-year history period and capped that window at 15 years as they accumulated more data.

The transparency of the benchmarks' methodology, which is available online, is considered by S&P and MSR as the most significant departure from what was previously available in the market.

Manager-based composite benchmarks are not investable or replicable by design because it's impossible for investors to know the specifics of each manager's strategy. Also, the underlying strategies are not available to all investors who would like to invest in them.

Another major problem is the so-called "survivorship bias" of such benchmarks, as they only track managers currently active in the market and don't include funds that for any number of reasons terminated their operations.

Some investors looking to avoid those headaches have opted to measure the success of their risk parity portfolios using a traditional 60/40 equities/fixed income mix. But such model portfolios did not reflect the construction or the risk/return expectations of the strategy.

The arrival of the new family of indices could serve as a catalyst for the evolution of risk parity, if asset allocators determine that the passive approach makes more sense for their portfolios. After all, risk parity, even though an active manager's game, as a systematic strategy theoretically allows for passive implementation.

"The demand for such strategies is still there," Srivastava notes. "What is changing is the increased focus on fees and transparency. People are not willing to pay the price of active managers."

Because of that, MSR's Brown points out that his firm prefers the word "replacement" to "replication" when it comes to describing what the Parsippany, New Jersey-based index provider is doing. "We intend to replace managers in investors' portfolios with rules-based, transparent and liquid alternatives," Brown says.

"The word 'replication' on the other hand has a history in the marketplace, and [its] use may (or may not) mislead a potential customer into thinking we employ replication techniques that have been around for many years, when we, in fact, do not employ such techniques."

Yet the lack of an appropriate benchmark has long hampered active managers who've seen their results compared to markets that, in some cases, they don't even cover. A widely recognised index that tracks the intricacies of what they do might provide some relief.

"When you go to an active manager and ask: 'why [did you] give me 2% while the S&P 500 gave me 20%?' you compare apples to oranges. We need to compare apples to apples," says Srivastava. With the new indices, he adds, the manager won't have to convince their clients that are being compared to an index that is not correct.
