While risk parity strategies have become widely understood and accepted by defined benefit (DB) plans, is the strategy transferable to the defined contribution (DC) world? Whether risk parity strategies are being mistaken for traditional balanced portfolios or creating concern about how they’ll fare in a rising rate environment, there’s no doubt they’re becoming a topic of conversation among DC plan sponsors and consultants.

In this Retirement Roundtable, a panel of experts provides insights about risk parity and where they are seeing the greatest acceptance and resistance.

Versus a traditional balanced portfolio

**Ruth:** Let’s start with you, Greg. When you meet with DC plan sponsors, are they skeptical about the risk parity investment approach? When does the discussion become hindered, or “get held up”?

**Greg:** When plan sponsors see something that resembles a balanced strategy, they tend to think of a traditional 60/40 portfolio. And, because risk parity may resemble a typical hybrid or a balanced approach on the surface, conversations usually begin with a discussion of the differences between risk parity and traditional balanced portfolios.

A risk parity approach allocates a portfolio of assets that are equally weighted on a risk basis. The primary benefit of this approach is to reduce the concentration of equity risk in a portfolio. In a 60/40 portfolio, as much as 90% of the portfolio risk may be attributed to the equities component.

Over the years, many people have the mindset that traditional 60/40 portfolios are the de facto moderate allocation or default for participants. So part of the challenge is getting plan sponsors to think not in terms of dollar allocation, but rather what your risk allocation looks like – which will be, by far, a primary determinant of returns.

**Dave:** I would also add that the return profile of risk parity results in more downside protection with meaningful participation on the upside. However, when equities dominate the return landscape, risk parity may underperform a typical 60/40 balanced portfolio, and that’s where we may see pushback from plan sponsors.

Because of the lack of potential upside participation, plan sponsors may have concerns that participants will abandon the strategy if it doesn’t have the upside momentum that a more equity-heavy strategy may provide.

Plan sponsors can’t prevent participants from making the wrong decisions, but they can provide the investment tools participants need to build diversified portfolios. However, I believe 2008 has left an indelible impression, and many participants may be less apt to chase returns.
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Use of leverage

Ruth: Discussions around the use of leverage are essential to DC conversations. Plan sponsors want to know how managers are using leverage in risk parity. How do you explain the process to sponsors so they have a level of comfort?

Dave: One thing I found interesting is the general lack of awareness about the prevalence of derivatives within a tremendous swath of otherwise ordinary-looking investment vehicles, such as intermediate-term bond portfolios.

When you put things in that context, the idea that risk parity providers are doing something unique or risky is tempered. People have to realize that the reason we use derivatives is because we believe it’s the most efficient and effective way to gain access to these market segments.

In comparison with a traditional allocation, the use of leverage is not directly tied to the overall risk, and in fact, a risk parity portfolio typically has lower risk even though it’s leveraged.

Additionally, risk parity strategies implement their leverage through instruments such as futures, versus borrowing, which effectively margins the portfolio. We primarily use futures contracts, which provided better liquidity during the financial crisis in 2008 than physical securities.

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If you consider the financial crisis of 2008, many investors had to sell securities into a declining market to cover their margin, and the selling further compounded their losses. In contrast, futures require a small, up-front margin and additional collateral is held in Treasury bills. Futures are marked to market daily, and when additional margin is required, it is obtained from the existing collateral pool versus having to sell securities in the portfolio. This difference in the approach to gain leverage is important for plan sponsors to understand.

Position in plan

Ruth: Greg, if I’m a plan sponsor evaluating risk parity as part of my investment menu, where does it fit? As a stand-alone option or as part of a custom target date fund?

Greg: We frequently get this question from plan sponsors. With respect to custom target date funds, risk parity can be used a few different ways. We have clients that are using risk parity as a volatility dampener in glide paths that have heavy equity exposure. In this scenario, a portion of the equity allocation is invested in a risk parity strategy. Since custom target date funds can have difficulty investing in illiquid alternatives, it can also be used as low-volatility, liquid alternative exposure.

Additionally, we’ve had larger clients include risk parity as a stand-alone option. What they see is something quite different compared with other investment options: They see low volatility and downside protection with reasonable expenses, and they view risk parity as an important part of their core lineup. Lastly, it also has the potential to be a plan’s default option in lieu of a traditional 60/40 balanced portfolio.

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1 Risk contribution refers to Invesco’s targeted strategic allocation whereby 1/3 of the overall targeted portfolio risk is assigned to various asset classes used within the strategy.
**Ruth:** Adding to a crowded lineup

It’s common knowledge that offering too many investment choices may cause participants to become overwhelmed and unable to make decisions. Plans are trying to find the right balance of quantity and quality of investment options. So why consider risk parity?

**Dave:** Like any changes to a plan’s investment lineup, plan sponsors need to evaluate the approach and how it may help plan participants. Risk parity may be beneficial as it provides exposure to asset classes that behave differently during three economic cycles participants will likely face – noninflationary growth, inflationary growth and recessionary periods.

Risk parity strategies also seek to distribute risk equally across three main asset classes – stocks, bonds and commodities. The portfolio is not weighted by return expectations, which results in risk being an unintentional output, but rather, we start by seeking to equalize the risk by asking ourselves, “What dollar allocation do we need to get there?” In other words, risk is the input, not the output.

As a result, risk parity may provide a smoother ride for participants across various economic cycles by reducing drawdowns and still participating meaningfully when markets are more prosperous. As participants get closer to retirement age, this becomes more imperative. There are few options in DC plans today that can offer this combination of benefits.

**Asset Allocation Provides Diversification Framework**

<table>
<thead>
<tr>
<th>Inflationary Growth</th>
<th>Recession</th>
<th>Noninflationary Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation hedges may include: Commodities, Direct Real Estate, Infrastructure, TIPS</td>
<td>Deflation hedges may include: Long-Term Government Bonds (hedged)</td>
<td>Growth assets may include: Developed Equities, Emerging Equities, Private Equity, High Yield/Credit</td>
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</tbody>
</table>

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**Dave:** Rising rate environment

**Ruth:** I understand risk parity strategies are designed to do well in different economic conditions. However, the biggest criticism I hear from clients is, “Risk parity worked well in a 30-year bond bull market with declining rates, but will it work during rising rates?”

**Dave:** Yes. Risk parity can work in a rising interest rate environment. A common misconception is that during periods of rising rates, performance will be similar to that of long-duration bonds due to the higher relative bond weight required to balance risk.

Among others, two key ways a risk parity strategy seeks to defend against a rising rate environment are strategic allocation and tactical allocation.

Let’s consider two ways interest rates can rise. One way is for growth to increase in the economy, while inflation remains contained. This results in an environment where unemployment falls to more normalized levels and the Federal Reserve may decide to incrementally raise interest rates so as not to reverse economic growth. In this type of environment, yields are rising, and therefore bond prices are falling. However, we would expect equities to rise, and potentially, more cyclical commodities such as energy and industrial metals.

A common misconception is that during periods of rising rates, performance will be similar to that of long-duration bonds due to the higher relative bond weight required to balance risk.

Alternatively, we could experience a period of inflation, which would also cause bond prices to fall. However, inflation typically hurts equity prices as well. Therefore, during periods of inflation, we expect commodities to be the leading asset class. In summary, the strategic allocation is designed to hedge against a variety of economic outcomes, which includes a period of rising rates.
We believe another advantage of risk parity is the ability to tactically adjust the portfolio. Tactical allocation allows managers to change both the absolute level of risk and the composition of risk. Depending on what environment is causing rates to rise – either growth or inflation – we can minimize our exposure to bonds, as well as bias the portfolio to equities or commodities, depending on what's more beneficial.

### Historical Behavior of Assets in Periods of Rising Rates

<table>
<thead>
<tr>
<th>Asset tends to rise in value</th>
<th>Asset has had an ambiguous response to the scenario</th>
<th>Asset tends to fall in value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rising Nominal Growth</td>
<td>Declining Creditworthiness</td>
<td></td>
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<tr>
<td>Primarily Due to Real Growth</td>
<td>Primarily Due to Inflation</td>
<td></td>
</tr>
</tbody>
</table>

- Government Bonds
- Corporate Bonds
- Stocks
- Commodities

Source: Invesco analysis. This table is intended to reflect the direction, but not the magnitude, of historic asset performance. Stocks represented by the S&P 500 Index, government bonds represented by Global Financial Data's 10-year Treasury Bond Index, corporate bonds represented by the Barclays US Corporate Bond Index and commodities represented by the Reuters/Jefferies – CRB Commodity Total Return Index. Based on full-month data from 1/31/1950 to 12/31/2012.

6 **Participant education**

**Ruth:** Let's move on to participation education. Greg, with risk parity being multifaceted, are plan sponsors finding it challenging to educate participants?

**Greg:** We have to take a step back and think about how participants want to be, and should be, educated on plan investment options overall. Do we need to explain to participants how an investment strategy actually works, or how the portfolio manager does his job?

For example, take intermediate-term bond strategies. Some of the most popular ones are actually quite complex under the surface. Is it truly worthwhile to try to explain how the manager uses derivatives to manage duration?

What is most important to participants is that they understand:
- What to expect from the strategy.
- How the strategy is likely to behave.
- What kind of volatility they might see with the investment option.

We believe when sponsors hold risk parity strategies to the same education standards and expectations as other options on the investment menu they do not find it challenging to educate participants. It’s a matter of perspective.

**Closing**

**Ruth:** I'd like to thank our distinguished contributors for their insightful commentary. With an increased reliance on DC plans to see participants through retirement, it's important for plan sponsors to consider alternative investment strategies, even if that means challenging widely held beliefs and practices.