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Is Risk-Factor Investing The Future For Institutional Portfolios?

I have written a lot on risk parity in recent weeks. Nothing I've written before has caused so many of you to respond. This is a good thing. I like getting emails. It makes me feel popular.

I wanted to take the discussion further, and tip my hand about our upcoming April Issue.

Rightly or wrongly, I view risk parity as part of a larger trend towards risk-factor investing. They both (seemingly) stem from the financial crisis: Asset owners, especially younger ones, seem increasingly convinced that forecasting returns in such a volatile market environment is a fool's game, and are thus more likely to focus on controlling risk (why risk is more easily forecast than returns eludes me slightly…). Product-wise, this realization has caused many to turn to risk parity "solutions," with an allocation of 5% to 8% becoming more common.

But beyond risk parity, this realization—that returns are perhaps impossible to forecast with any accuracy—has also led to the idea that whole portfolios can be reclassified along risk lines. In the simplest terms, I think of risk parity as a product, and risk-factor investing as a paradigm.

You see it more outside the US than inside it (although some American funds are starting to discuss it)—but there is a real disagreement between funds about what, exactly, those risk factors should be.

Angelo Calvello, our long-running columnist, addresses this issue in the upcoming April Issue (which also includes are ever-popular *Forty Under Forty*). He writes:

These definitional issues give rise to another complicating issue: there is no universal taxonomy of risk factors. There isn't even a general ideological constellation. The Norway Government Pension Fund, which I believe is one of the leaders in risk-factor investing, has identified ten factors: Term, credit Aa, credit Baa, credit high yield, FX carry, liquidity, value/growth, small cap/large cap, momentum, and volatility. Danish pension fund PKA, another leader, allocates to seventeen risk premia in its equity portfolio, including developed markets, emerging markets, frontier markets, small cap, low volatility, dividends, implied volatility, momentum, value, quality, merger arb, liquidity, and "other tactically traded risk premiums." Wyoming Retirement Systems says it is using three risk factors in its equity portfolio: size, value, and low-volatility risk premia equities.

CalSTRS is considering six factors: growth risk, private growth, absolute return, growth diversify, inflation risk, interest rates, and interest rate uncertainty. BlackRock claims six factors, too, but names real rates, inflation, credit, liquidity, political, and economic. PIMCO, at times, suggests five risk factors, but elsewhere identifies thirteen of them. And Callan claims, "Factors come in a nearly infinite number of flavors."

We want feedback: (a) this move towards classifying portfolios along risk lines a trend or fad? and (b) Who, if anyone, has got these classifications right?

I have my initial opinions. They are:

(a) Yes—and I think that within five years you will see a wholesale change towards this style of portfolio definition. Having an "Equity, Fixed Income, Alternatives" structure will be as antiquated as having a Yahoo! email account.

(b) Probably no one, yet.