The Zen of risk parity and Richard Nixon's surprise benefit

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Richard Nixon breaking with the Bretton Woods agreement in 1971, marking the end of the gold standard, Robert M Pirsig's influential philosophical novel "Zen and the Art of Motorcycle Maintenance", first published in 1974, and the formation of Bridgewater Associates by Ray Dalio as an advisory and asset management firm in 1975 are connected, believe it or not, through what has become the present day phenomenon of risk parity investing.

Stay with the story... It actually makes it easier to understand why and how risk parity investing works. In fact, this latest fad probably has sufficient runs on the board to be considered a firm trend, notwithstanding lingering naysayers.

Bridgewater put together the first fund based on the principles of risk parity in 1996, aptly called the All Weather fund. But the principles go back to the 1950s and the development of Modern Portfolio Theory. It was in 1971, when Ray Dalio, fresh out of university and already a deft day-trader with his own money while working as a clerk at the NYSE, witnessed Richard Nixon's speech on television and fully expected the stock market to react negatively the following day. It didn't. The market jumped 4% and the price of gold also rose.

Dalio was confused, so he set out to understand why. According to Bridgewater history, he dissected the cause-effect linkages from the effective dollar devaluation which followed the end to the fixed exchange rate that President Nixon had announced. In a paper on the All Weather fund on its website, Bridgewater says:

> "Ray realised he could understand the economic machine by breaking down economies and markets into their component pieces, and studying the relationships of these pieces through time. This type of thinking is central to All Weather.
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> "For instance, any market move can be broken down into a few key components. Markets move based on shifts in conditions relative to the conditions that are priced in. This is the definition of a surprise. The greater the discrepancy, the larger the surprise. That explained the Nixon rally.
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> "When countries have too much debt and their lenders won't lend them more, they are squeezed. They, in this case the US, invariably print money to relieve the squeeze. The unexpected wave of new money cheapens its value and alleviates the pressure from tight monetary conditions sending stocks and gold higher. What Ray

> observed was "another one of those" - a shift in conditions relative to what people had expected."

It is the breaking down of the world and everything in it into the component parts that also brought on the cult classic philosophical novel "Zen and the Art of Motor Cycle Maintenance", a book which was recommended reading for a generation of political economy students at a time when the US was still in the Vietnam War and the counter cultural revolution was in full flight.

In the book, Pirsig takes the reader on a motorcycle trip across the northwest of America, undertaken by a man who appears to be descending into madness, and his young son. The man is all about simplicity and transparency, questioning modern society at every turn. He shuns highways in favour of the natural beauty better evident from small and windy country roads. He is also on a search for understanding. He observes a bunch of yokels, for instance, who have just bought a new washing machine only to take it apart as soon as they get home so they can find out how it works. He, of course, does his own motorcycle maintenance too.

Originally built for Ray Dalio's own trust assets, the All Weather fund is predicated on the notion that asset classes react in understandable ways based on the relationship of their cash flows to the economic environment. The fund does not aim to predict markets.

Dalio was a self-confessed loner as a child, which is why he began trading shares as a hobby. By the mid-1990s, he wanted a family trust whose asset allocations mapped out all economic environments and would remain resilient after he passed away. The upshot was four equal-weighted baskets of assets, with 25% of risk in each. Two were 'growth' quadrants and two 'inflation' quadrants. Each was divided into conditions of rising market expectations and falling market expectations.

The equal weighting of risk across the portfolio is the nub of risk parity investing, which today appears ideal for the retiree market, in particular. It usually involves gearing the less risky portfolios, such as bonds, and hedging the more risky, such as shares, so underlying allocations can remain the same. Bridgewater says: "In essence, All Weather can be sketched out on a napkin. It is as simple as holding four different portfolios each with the same risk, each of which does well in a particular environment: when (1) inflation rises, (2) inflation falls, (3) growth rises, and (4) growth falls relative to expectations."

Risk was a dominant discussion point at this year's PortfolioConstruction Forum Conference in late August. There were two distinct sessions on risk parity, another on the return outcomes from investing for risk, and several more in which risk - or at least as measured by volatility - took centre stage.

In discussions on various risk premia and whether or not they were really enduring, Tim Farrelly, the specialist asset allocation researcher, probably offered the best advice: "Never take risk premia for granted." he questioned the small-cap effect, which has generally been discredited, and even the value effect, shown to produce outperformance over very long periods, which he said was more a behavioural phenomenon than a risk premium. The equity risk premium, too, might not be as reliable as you might think because there have been many five and 10-year periods when it has been negative. Farrelly's view is that the two main risks in investing are the economy and inflation, which fits neatly with Ray Dalio's views. The key personal risks for investors are exuberance and mismanagement, he said.

Cliff Asness, co-founder and CIO of AQR Capital, who has been managing risk parity portfolios since 2006, believes that there is a low-beta premium whereby stocks with lower volatility tend to outperform. This factor has been increasingly used in the construction of multi-asset portfolios, but some question how persistent this will be over time.
Asness said AQR tested back to 1926 and found that equities had become more expensive since then and that bonds had basically “done a round trip”. He said: “Over long periods, the diversification benefit [of risk parity] does enough to swamp being in a single asset class.”

He was supported by Michael Kitces, research director with Washington DC-based high net worth advisory firm, Pinnacle Advisory, who questioned why bond portfolios were inevitably compared with equities "as the default" portfolio.

"Fundamentally, risk parity is just about better diversifying your exposure to risk and letting the even risk premia deliver the returns, as it eventually will, without taking a view or making a forecast," Kitces said.

Asness conceded, after a question from Lonsec's co-CEO and investment head, Amanda Gillespie, that leverage introduced a separate risk in risk parity investing. It also limits the portfolios to liquid asset classes.

Whether or not low beta stocks represent a sustainable premium, the recent low-volatility climate may not be a good thing for investors. For instance, volatility is currently as low, in all asset classes, as it was in 2007 prior to the global crisis.

Chris Watling, the CEO and chief market strategist at Longview Economics in London, said volatility tended to reach its low point around the middle or in the final one-third of the cycle. At the moment, the perception of the corporate sector was "terrific", with earnings growth accelerating and corporate bond spreads tight, signifying low risk, he noted.

"This is all about cheap money supporting the healing of the corporate sector," Watling said. "But, it also allows for vulnerability and excesses to continue coming out of the recession. UK interest rates have been near zero for five years, which is the longest period since the Bank of England was created in the 17th century."

Cheap money has changed the relationship between capital stock and GDP, creating unreal valuations across the board, he said. "The cyclical bull market for equities may have another 12 months to run, possibly 24 months or a bit more, but I doubt it."

Watling predicted that the first interest rate hike in the US would occur about June next year, before unemployment slips below 4%, which his firm is predicting for March 2016. "The cheap money days are over and volatility will head higher," he argued.

The places which lose most in such an environment, he warned, are those with economies that have been the longest without recession, where housing and other assets are overpriced and where confidence is high. Sounds like Australia.

While volatility has long been the standard measure of risk, it probably doesn't really reflect the average person's idea of risk, which is more akin to volatility on the downside. Jack Gray, adjunct professor of economics at UTS and director of fund manager, Brookvine, said that for risk to be captured by a single number measuring volatility was "outrageous" – however, he added that it was "not a bad proxy".

There are many misperceptions of risk. For instance, Gray said, anyone who visits Australia worries about being eaten by a shark or bitten by a spider, even if they never go into the ocean or leave a capital city. And, they are more worried than the odds would indicate about dying in a plane crash. "We're seeing the world as we'd like it to be rather than how it is," he said.

Some risks people perceive were difficult to measure, such as the risk of looking foolish or career risk. "The real thing that we're after is meaning," Gray said. "It's subjective and it's complex. We shouldn't try to pretend that the measurement is any more objective than it is. Uncertainty isn't risk. Uncertainty is a situation where there is no data."

Greg Bright is publisher of Investor Strategy News. Bright was a guest of PortfolioConstruction Forum at PortfolioConstruction Forum Conference 2014.