Risk Parity Rebuffed: Dalio versus Ineichen

By, Barclay T. Leib
Vice President & Portfolio Manager

Risk is a topic well-worn and trafficked, and not entirely popular within a current investment world where total portfolio returns are hard to come by. In today's markets, it is fine to be "risk conscious," but perhaps more important to many advisors is not to lose clients by being so.

And different people address risk – and indeed, even define risk – in different ways.

Earlier this year -- live from Davos, Switzerland courtesy of CNBC -- I watched Bridgewater's Chairman Ray Dalio espouse that the way to invest in 2013 should be a function of relative volatilities. Dalio's argument basically went that within a low-return world -- and with fixed income generally delivering less than half the volatility of equity investing -- a portfolio could and should be constructed on a risk neutral basis by levering the fixed income portion of a portfolio to equate to the risk equivalent of the equity portion. The term used was "risk parity" investing, and I soon learned that Dalio was this concept's most well-known and influential cheerleader.

I watched aghast. In my mind, Dalio's proposed path would work only in so far as global central bankers could maintain an orderly macro world. If the markets ever started to revolt against the powers of a QE, or the central bankers themselves started to have second thoughts about QE, I thought Dalio would be like the Pied Piper leading his clients off a cliff of potential portfolio problems. After all, with Treasury bonds at or near 30-year yield lows, who really wants a levered fixed income portfolio?

As a long-time friend of Dalio's, and in the spirit of Bridgewater's espoused culture of "radical transparency," I sent Dalio a somewhat scathing email with my opinions -- for which he dutifully responded with a note of thanks. But that did not stop Bridgewater from delivering a dose of acute return disappointment to its investors across the May-June period of fixed income market price weakness. More recently, Dalio has started to express concern that central bankers are "losing their economic effectiveness," but has yet to propose a new allocation solution to this situation.

One market analyst who does understand risk a bit differently – and perhaps better than Dalio -- is Alexander Ineichen of Ineichen Research and Management. Ineichen, a long-term scholar of markets previously at UBS, recently penned the article "When Reality Kicks" to which he has graciously granted us the following link: http://www.ineichen-rm.com/images/stories/pdf/when%20reality%20kicks.pdf

Within this article – which I highly recommend -- Ineichen follows the logic of Professor Mark Buchanan that traditional equilibrium economic thinking (that so many of us learned within our Samuelson Econ 101 texts) is actually quite passé. Per the Ineichen/Buchanan view, markets and economies behave more in a fractal matter like the weather, where small incremental changes (think “Butterfly Effect”) can and do build into occasional tornadoes and typhoons. Such “tail risk” events are actually normal and to be expected both in the natural world and -- by extrapolation -- within our capital markets. And yet, when central bankers try to suppress these occasional market tornadoes and typhoons, traditional Austrian economic analysis would suggest that the ultimate storms that build will only be more severe.

Within such a world, risk is perhaps better defined not by the relative volatilities of two investment assets but more by the risk of permanent capital impairment from a portfolio allocation mistake. In Ineichen’s words: “When risk for an asset class is defined as “potential years under water in real terms,” i.e. the longevity of capital compounding negatively, bonds are more risky than equities.”

In other words, everyone currently gravitates to bonds as their modicum of a “safe boring asset,” and modern portfolio theory certainly shows that combining equities and bonds makes perfect sense because their correlation coefficient is typically less than one. And yet, what if the last thirty years for bonds was essentially one regime – one massive credit expansion? Might a portfolio heavily weighted towards bonds today actually represent a more risky portfolio from an intermediate-term capital impairment risk point of view than one more heavily weighted toward equities? Or maybe, per yet another academic thinker, Dr. Andrew Lo of MIT, the true last frontier of efficient allocation theory (yet to be broadly learned by most allocators today) will be for investors to learn how to *short* assets.

To a certain extent, we’ve seen this movie before, but few remember it. Post Word War II, the debt-to-GDP ratio in the U.S. was higher than it is today, and the policy response was to keep rates pegged at artificially low wartime levels for multiple years, and then only slowly allow rates to rise. Bondholders received real returns that were significantly negative and became only worse on a mark-to-market basis over the next two decades.

I value Ineichen’s vision of risk more than Dalio’s vision. I encourage our clients to spend the requisite time reading Ineichen’s thought-provoking piece.