

Problem Set 2: Risk Parity

Professor Bernard Herskovic
bernardherskovic@anderson.ucla.edu
Office: Room C-413

Due on week 4 before class. This is an **individual assignment**, but you can discuss it with your classmates. If you discuss with other classmates, indicate their names in your write-up. Please submit R code as well as a separate write-up. Explain the procedure and your answers clearly in the write-up (such that someone unfamiliar with the problem could solve it). Code must be formatted as instructed in order to receive a grade. Use CCLE to submit your answers.

You should submit two files:

- .R **PS2_YourStudentID** (for example, PS2_012345678.R), with **only** the functions described below and the packages needed to run them
- .pdf **PS2_YourStudentID** (for example, PS2_012345678.pdf), with discussion on how you answered the questions written below, as well as responses to any particular questions asked

1. Construct the equal-weighted market return, value-weighted market market, and lagged total market capitalization using CRSP Bond data ¹. Your output should be from January 1926 to December 2015, at a monthly frequency.

- Function name: **PS2_Q1**
 - Inputs
 - * data.table **CRSP_Bonds**, with columns:

Variable Name	Variable type
KYCRSPID	Character
MCALDT	Date
TMRETNUA	Numeric
TMTOTOUT	Integer

- This should be the data as pulled from WRDS, with one exception. Format the MCALDT column as a Date type.

¹ Available at WRDS: <https://wrds-web.wharton.upenn.edu/wrds/>. Bond data are available from WRDS: CRSP > Annual Update > Treasuries > CRSP TREASURIES - Issue Descriptions and Monthly Time Series.

– Output

- * data.table, with each row corresponding to a unique year and month, with columns

Variable Name	Variable type	Variable description
Year	Integer	Year
Month	Integer	Month
Bond_lag_MV	Integer	Total market value the previous month (in millions)
Bond_Ew_Ret	Numeric	Equal-weighted returns
Bond_Vw_Ret	Numeric	Value-weighted returns

- Note: Returns should be formatted in decimal proportion (not percent).

2. Aggregate stock, bond, and riskless datatables. For each year-month, calculate the lagged market value and excess value-weighted returns for both stocks and bonds. Your output should be from January 1926 to December 2015, at a monthly frequency.

- Function name: **PS2_Q2**

– Inputs

- * data.table **Monthly_CRSP_Stocks**, an extended version of the output of **PS1_Q1** (Jan 1926 - Dec 2015 instead of Feb 1926 - Dec 2015).
- * data.table **Monthly_CRSP_Bonds**, the output of **PS2_Q1**
- * data.table **Monthly_CRSP_Riskless**, with columns:

Variable Name	Variable type
caldt	Date
t90ret	Numeric
t30ret	Numeric

- This should be the data as pulled from WRDS, with one exception. Format the caldt column as a Date type.

– Output

- * data.table, with each row corresponding to a unique year and month, with columns

Variable Name	Variable type	Variable description
Year	Integer	Year
Month	Integer	Month
Stock_lag_MV	Numeric	Total market value the previous month (in millions)
Stock_Excess_Vw_Ret	Numeric	Value-weighted return above riskless rate
Bond_lag_MV	Integer	Total market value the previous month (in millions)
Bond_Excess_Vw_Ret	Numeric	Value-weighted return above riskless rate

- Note: Returns should be formatted in decimal proportion (not percent).

3. Calculate the monthly unlevered and levered risk-parity portfolio returns as defined by Asness, Frazzini, and Pedersen (2012).² For the levered risk-parity portfolio, match the value-weighted portfolio's $\hat{\sigma}$ over the longest matched holding period of both.

- Function name: **PS2_Q3**

- Inputs

- * data.table **Monthly_CRSP_Universe**, the output of **PS2_Q2**

- Output

- * data.table, with each row corresponding to a unique year and month, with columns

Variable Name	Variable type	Variable description
Year	Integer	Year
Month	Integer	Month
Stock_Excess_Vw_Ret	Numeric	
Bond_Excess_Vw_Ret	Numeric	
Excess_Vw_Ret	Numeric	Value-weighted portfolio return above riskless rate
Excess_60_40_Ret	Numeric	60-40 portfolio return above riskless rate
Stock_inverse_sigma_hat	Numeric	As defined by Asness et al. (2012)
Bond_inverse_sigma_hat	Numeric	As defined by Asness et al. (2012)
Unlevered_k	Numeric	As defined by Asness et al. (2012)
Excess_Unlevered_RP_Ret	Numeric	Unlevered RP portfolio return above riskless rate
Levered_k	Numeric	To match $\hat{\sigma}$ of Excess_Vw_Ret
Excess_Levered_RP_Ret	Numeric	RP portfolio return above riskless rate

• Note: Returns should be formatted in decimal proportion (not percent).

²“Leverage Aversion and Risk Parity” by Clifford S. Asness, Andrea Frazzini, and Lasse H. Pedersen (2012, Financial Analysts Journal, Volume 68, Number 1).

4. Replicate and report Panel A of Table 2 in Asness, Frazzini, and Pedersen (2012), except for Alpha and t-stat of Alpha columns. Specifically, for all strategies considered, report the annualized average excess returns, t-statistic of the average excess returns, annualized volatility, annualized Sharpe Ratio, skewness, and excess kurtosis. Your sample should be from January 1929 to June 2010, at monthly frequency. Discuss the difference between your table and the table reported in the paper. It is zero? If not, justify whether the difference is economically negligible or not. What are the reasons a nonzero difference?

- Function name: **PS2.Q4**
 - Input
 - * data.table **Port_Rets**, the output of **PS2.Q3**
 - Output
 - * 6×6 numeric matrix, reproducing part of the Long Sample subtable. Match the formatting of the paper to the extent possible. Rows: CRSP stocks, CRSP bonds, Value-weighted portfolio, 60/40 portfolio, unlevered RP, and levered RP. Columns: Annualized Mean, t-stat of Annualized Mean, Annualized Standard Deviation, Annualized Sharpe Ratio, Skewness, and Excess Kurtosis.