

9. SMART BETA STRATEGIES: RISK BUDGETING AND PARITY

Prof. Gordon Ritter

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9.1. Risk Budgeting. We begin by recalling Euler's homogeneous function theorem.

Theorem 9.1 (Euler). Let $f(x_1, \dots, x_k)$ be a smooth homogeneous function of degree n . That is,

$$f(tx_1, \dots, tx_k) = t^n f(x_1, \dots, x_k). \quad (9.1)$$

Then the following identity holds

$$x_1 \frac{\partial f}{\partial x_1} + \dots + x_k \frac{\partial f}{\partial x_k} = n f.$$

Proof. By homogeneity, the relation (9.1) holds for all t . Taking the t -derivative of both sides, we establish that the following identity holds for all t :

$$x_1 \frac{\partial f}{\partial x_1}(tx_1, \dots, tx_k) + \dots + x_k \frac{\partial f}{\partial x_k}(tx_1, \dots, tx_k) = nt^{n-1} f(x_1, \dots, x_k).$$

To obtain the result of the theorem, it suffices to set $t = 1$ in the previous formula.

□

Sometimes the differential operator

$$x_1 \frac{\partial}{\partial x_1} + \dots + x_k \frac{\partial}{\partial x_k}$$

is called the *Euler operator*. An equivalent way to state the theorem is to say that homogeneous functions are eigenfunctions of the Euler operator, with the degree of homogeneity as the eigenvalue.

Let us consider a portfolio of n assets. We define x_i as the exposure of the i -th asset and $R(x)$ as a risk measure for the portfolio $x = (x_1, \dots, x_n)$. Note that, at this level of generality, the x_i could just as well be exposures to factors (such as style premia) instead of exposures to individual assets.

Assume $R(x)$ is homogeneous of degree 1, or in other words $R(tx) = tR(x)$. Then by Euler's theorem one has

$$R(x) = \sum_{i=1}^n x_i \frac{\partial R}{\partial x_i}$$

One says the risk measure is the sum of the product of exposure times marginal risk.

Define the *risk contribution* of the i -th asset (or factor) as follows:

$$\text{RC}_i(x) = x_i \frac{\partial R}{\partial x_i}$$

We consider a set of given risk budgets $\mathbf{b} = \{b_1, \dots, b_n\}$. Here, b_i is an amount of risk measured in dollars (or any appropriate numéraire). We typically assume $b_i > 0$, ie. the various assets or factors are things we want to allocate risk to.

Definition 9.1. The *risk budgeting portfolio* is then defined by the following system of nonlinear equations:

$$\text{RC}_i(x) = b_i \quad \forall i = 1, \dots, n. \quad (9.2)$$

A special case is the *equal risk contribution (ERC)* portfolio in which all $b_i = 1/n$.

The most commonly studied risk measure is volatility,

$$R(x) = \sigma(x) = (x' \Sigma x)^{1/2}$$

In this case, the marginal risk and the risk contribution of the i -th asset are respectively:

$$\frac{\partial R}{\partial x_i} = \frac{(\Sigma x)_i}{\sigma(x)}, \quad \text{and} \quad \text{RC}_i = x_i \frac{(\Sigma x)_i}{\sigma(x)}.$$

Note that if the asset returns are Gaussian, the value-at-risk of the portfolio is:

$$\text{VaR}(x; \alpha) = \Phi^{-1}(\alpha) \sigma(x)$$

where Φ is the CDF of the normal distribution. It is useful to memorize the most commonly-used values of Φ^{-1} for quick mental calculations:

$$\Phi^{-1}(0.95) \approx 1.64 \quad \text{and} \quad \Phi^{-1}(0.99) \approx 2.33 \quad (9.3)$$

So the 95% 1-day VaR for a normal distribution is approximately 1.6 times its daily volatility.

Similarly, the expected shortfall assuming a normal distribution is given by

$$\text{ES}(x; \alpha) = \frac{1}{2\pi(1-\alpha)} \sigma(x) \exp \left[-\frac{1}{2} \Phi^{-1}(\alpha)^2 \right] \quad (9.4)$$

Note that (9.3) and (9.4) are both proportional to $\sigma(x)$, so for normally-distributed returns, risk budgeting via $\sigma(x)$ could be trivially translated into budgeting via *VaR* or *ES* by multiplying the risk budgets by suitable factors involving $\Phi^{-1}(\alpha)$. Hence in what follows, we mostly focus on $R(x) = \sigma(x)$.

Let $\beta_i(x)$ denote the beta of asset i to a portfolio x , ie

$$\beta_i(x) = \frac{\text{cov}(r_i, x'r)}{\text{var}(x'r)} = \frac{(\Sigma x)_i}{x' \Sigma x} = \frac{(\Sigma x)_i}{\sigma(x)^2}$$

Hence the risk contribution is

$$x_i \beta_i(x) \sigma(x) = x_i \frac{(\Sigma x)_i}{\sigma(x)} = \text{RC}_i$$

If x is a solution to the risk-budgeting problem (9.2), then $\text{RC}_i(x) = b_i$ so we have for any pair i, j

$$\begin{aligned} x_i \beta_i(x) \sigma(x) &= b_i \\ x_j \beta_j(x) \sigma(x) &= b_j \end{aligned}$$

Divide the first equation by the second:

$$\frac{x_i \beta_i(x)}{x_j \beta_j(x)} = \frac{b_i}{b_j} \Rightarrow b_j x_i \beta_i(x) = b_i x_j \beta_j(x)$$

where again, the latter holds for all i, j assuming x is a solution to (9.2).

Moving things around,

$$b_j \beta_j(x)^{-1} x_i = b_i \beta_i(x)^{-1} x_j$$

Then sum both sides over j to find

$$x_i = \frac{b_i \beta_i(x)^{-1}}{\sum_j b_j \beta_j(x)^{-1}} \cdot \sum_i x_i$$

This does *not* constitute a solution to the problem, since x appears on both sides, but it does help us understand the problem by telling us a property that the solutions must have at optimality: the weight allocated to the component i is inversely proportional to its beta to the portfolio.

One can find risk-budgeting portfolios by the most classical method imaginable: least squares. Referring to (9.2), one can solve:

$$x^* = \underset{x}{\operatorname{argmin}} \sum_{i=1}^n (\text{RC}_i(x) - b_i)^2.$$

This is nonlinear least squares as $\text{RC}_i(x)$ is typically a nonlinear function of x . The least-squares function is of course bounded below by zero, so the problem has at least one solution. It is natural to wonder whether the solution exists and/or is unique. This is answered by showing that the problem is equivalent to a convex optimization problem, as we now show.

Assume $\Sigma \succ 0$ is positive-definite, hence the following optimization problem is strictly convex:

$$\min \sigma(y) \quad \text{subject to} \quad \sum_i b_i \ln y_i \geq c \quad \text{where:} \quad \sigma(y) = (y' \Sigma y)^{1/2}$$

where c is an arbitrary constant. Note that the domain of the problem \mathcal{D}

$$\mathcal{D} = \{y \in \mathbb{R}^n : y_i > 0 \forall i = 1, \dots, n\}$$

because the constraint function isn't defined outside of this domain.

The Lagrangian is

$$L(y, \lambda) = \sigma(y) - \lambda(\sum_i b_i \ln y_i - c)$$

Note that the constraint will be active at optimality, because if we remove it, the solution would be $y^* = 0$ which isn't in the domain of the problem. Another, possibly more intuitive way to see this is as follows: start with any feasible point y . As we move y increasingly close to the origin in the norm $\sigma(y)$, the components of y become smaller, and $\ln y_i$ could be made arbitrarily negative, so by the intermediate value theorem eventually we hit $\sum_i b_i \ln y_i = c$. Hence at optimality $\lambda^* > 0$; we can then interpret the role of the arbitrary constant c : it serves to determine the Lagrange multiplier λ^* . We shall see that the value of λ^* is arbitrary – it just rescales the portfolio.

Consider the Lagrangian first-order condition:

$$\begin{aligned} (\nabla L)_i &= \frac{\partial \sigma(y)}{\partial y_i} - \lambda \frac{b_i}{y_i} = 0 \\ \Rightarrow y_i \frac{\partial \sigma(y)}{\partial y_i} &= \lambda^* b_i \end{aligned}$$

This means we have shown that the risk contributions are proportional to the risk budgets. Hence (up to a scaling) y solves the risk-budgeting problem.

The von Neumann Morgenstern theorem implies that any *rational* investor must have a utility function, and such an investor decides between different lotteries by optimizing expected utility of wealth. Hence various investment schemes and theories and such must be regarded with suspicion unless they can be derived from utility theory somehow. Mean-variance optimization corresponds to expected utility maximization under the assumption that the multivariate distribution of asset returns is elliptical. It is natural to wonder whether the ERC portfolio is optimal under any reasonable assumptions.

Theorem 9.2. Let R be the correlation matrix of asset returns. Suppose that

$$R\mathbf{1} = m \cdot \mathbf{1}$$

where $\mathbf{1} = (1, 1, \dots, 1)$ denotes a vector of ones. Suppose further that all assets have the same ex ante Sharpe ratio. Then the mean-variance optimal portfolio coincides with the risk-parity portfolio, and both have weights proportional to inverse volatility.

Proof. Let $S = \text{diag}(\sigma_1, \dots, \sigma_n)$, then the Sharpe ratio assumption is $S^{-1}\mu = \eta \cdot \mathbf{1}$ for some constant η . The asset return covariance matrix satisfies $\Sigma^{-1} = S^{-1}R^{-1}S^{-1}$. The mean-variance optimal portfolio has weights proportional to

$$\Sigma^{-1}\mu = S^{-1}R^{-1}S^{-1}\mu = \eta S^{-1}R^{-1}\mathbf{1} = \eta m S^{-1}\mathbf{1}.$$

Hence the mean-variance portfolio is proportional to inverse-volatility weighting. We leave it as an exercise to show that the ERC portfolio has the same weights.

□

For a (mean-variance) optimal portfolio, the ratio of the marginal excess return to the marginal risk is the same for all assets, and equals the ex ante Sharpe ratio of the portfolio:

$$\frac{\partial_i \mu(x)}{\partial_i \sigma(x)} = \text{SR}(x) \quad \text{for all } i = 1 \dots n.$$

where $\partial_i \equiv \partial/\partial x_i$. Note that these expressions simplify substantially. Letting $\mu = \mathbb{E}[r - r_{rf}] \in \mathbb{R}^n$ denote the expected excess returns, one has $\nabla \mu(x) = \mu$ and $\nabla \sigma(x) = \Sigma x / \sigma(x)$. Therefore the above is equivalent to:

$$\mu = \text{SR}(x) \frac{\Sigma x}{\sigma(x)} = \text{SR}(x) \frac{\partial \sigma(x)}{\partial x_i}$$

In other words, given any risk-budgeting portfolio, we can derive the μ that makes it also mean-variance optimal by noting that the μ_i must be proportional to the marginal risks $\partial \sigma(x) / \partial x_i$.

Risk parity is often used to analyse a basic investment problem involving the optimal allocation to equities and bonds. Equity returns are far more volatile, so the ERC portfolio strongly down-weights equities.

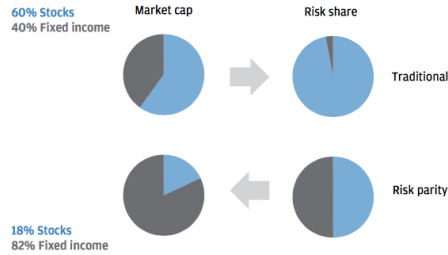


FIGURE 9.1. Traditional vs Risk Parity Allocation

The difference in weighting has a strong effect on the resulting performance.

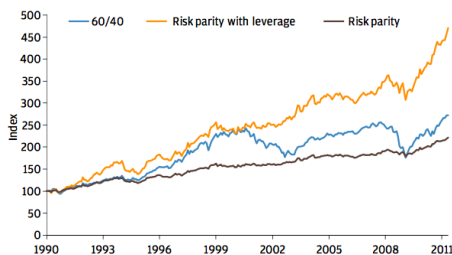


FIGURE 9.2. Performance of Traditional vs Risk Parity Allocation Since 1990

However, there are several important things going on here. If it happens that the Sharpe ratios are the same, then one point of view is that risk parity is performing well not because it's a good method, but because it's finding the mean-variance optimal portfolio by accident. It's also important to note that bonds have enjoyed a 30-year bull market which mostly encompasses the period over which we have reliable daily returns. Over such a period, any method which over-weights bonds relative to equities will realize a higher Sharpe ratio.

Lastly, let me say please be careful when reading the literature in this area. We are still mathematicians, even though we focus on an applied field of mathematics (mathematical finance). Mathematicians only make statements they can prove. Statements that are overly vague are the same as false statements. In doing a literature review for these notes, I encountered more than the usual amount of nonsense. For example, one paper stated:

The main difference between RB and MVO portfolios is that the last ones are based on optimization techniques. It implies that MVO portfolios are very sensitive to the inputs.

— Bruder and Roncalli (2013)

From the same paper:

Mean-variance optimization, however, generally leads to portfolios concentrated in terms of weights.

— Bruder and Roncalli (2013)

These statements are, of course nonsense or misleading. Mean-variance optimization generally leads to very well diversified portfolios if the return-generating process is of the APT form we have studied extensively in this class.