**With Risk Budgeting, Investing Is Less of a Risky Business** by Wolcott Wheeler

By employing sophisticated risk budgeting techniques, JP Morgan Asset Management enables its clients of all stripes to mitigate and even control investment risk. VP Ian Ngo recently explained to us how the process works.

Portfolio construction is a multi-step process. The first step is strategic asset allocation—how much will you be investing in fixed income, how much in equities? Let’s say you plan to put 50% in equities and 50% in fixed income. The next step is, which managers do you want to fill in those asset class buckets?

Risk budgeting allows you to quantify the risk originating from your selection of asset classes and the risk created by your selection of managers, and to assess how the two come together to generate your total portfolio risk.

Needless to say, risk is paramount to clients. They want to know, “How much risk am I taking by playing in the equity and fixed income sandbox?” and “How much risk am I incurring by choosing certain managers?”

Ngo listed several concepts clients need to take into account. First is beta risk—strategic asset allocation risk, originating from how much capital you plan to invest in these asset class buckets. Let’s take bonds as an example. Your asset weight is the amount of capital you invest in bonds. Your stand-alone risk is the volatility of the bond market, measured by the Barclays Aggregate Index, the volatility benchmark for bonds.

Then there is alpha risk, which involves conscious investment choice. Alpha risk depends on your choice of managers. It would be wisest to spread your 50% in equities and your 50% in bonds among several managers, so you could benefit from differing investment styles, thereby mitigating risk exposure.

JP Morgan Asset Management’s risk budgeting tool allows you to quantify how much risk is inherent in your choice of asset allocation and how much risk you’re taking by selecting a given pool of managers. This, in turn, affects the amount of risk and the amount of return you receive from your investment. It’s the job of the asset manager to help the client understand the risk of his or her decision.

Asset correlation is also very important. How is your bond portfolio correlated with your equities portfolio? If you split your bond/equity allocation 50/50, as in this example, you’re inviting a different measure of risk than if you invested in, say, 25% in bonds and 75% in equities. Your asset correlation is a decision that necessarily entails volatility, since bonds and equities have a negative correlation: when bonds go up, equities go down, and vice versa. By choosing one asset correlation over another, your risk profile and return expectations will be different, and each investor will assume a different measure of risk, depending on their unique asset correlation. The asset manager analyzes the relationship between a client’s choice of asset allocations (and asset correlation) and a client’s choice of managers.

Let’s say you’ve chosen 10 managers to invest your 50% investment in equities. You don’t want managers all with the same investment style—you want 10 managers who are doing something different, so their asset-class risk correlations vary. But you want to be certain your managers aren’t either 100% correlated to each other (meaning they’re all pursuing the same strategy), or to have them completely different, because the latter would result in an investment strategy that was totally askew. This process is the basis of risk manager portfolio attribution.

JP Morgan Asset Management works closely with clients to help them achieve and adjust their risk/reward expectations. If a client generates a 7% return with 15% volatility using 10 managers, but another investor supported by only four managers is receiving a 15% return with a matching 15% volatility, JP Morgan can help that client optimize to identify which of his or her managers are underperforming, so the client can switch managers and work with others who can increase the rate of return.

It’s important for clients to match their return expectations with volatility they can accept. There’s no reward without risk. Some clients would rather receive a lower rate of return, if it means a lower rate of volatility, so they don’t incur potential loss of capital. But other clients may have a greater risk appetitite, because their desire for a higher rate of return offsets the risk presented by higher volatility.

Ngo cited the example of how JP Morgan deals with a range of endowments that vary widely. One college might be a smaller liberal arts school; the other might be a large university. They might have the same amount of money to invest—say a billion dollars. But the smaller college, with a smaller number of students, may be primarily interested in maintaining its endowment and not risking it—growth isn’t a goal. Yet the university may want to grow—it has a large student body, it wants to acquire land, it wants to build. And if it grows, since it will attract more students, it will receive more tuition; as a result, the university is not only investing in its future, it is directing capital in the expectation of a return generation. Clearly these two endowments, with the same amount to invest, have two very different risk/return profiles.

As Ngo noted, some clients are comfortable with volatility. Where retirees may be content with a lower rate of return based on lower volatility, a recent college graduate might be happy to accept a greater measure of risk in exchange for a higher return, because the younger investor has more of his or her future to gamble with.

When clients declare they’re seeking a targeted rate of return, JP Morgan advises them of the correlated degree of volatility, and the investment choice depends on the individual client’s risk tolerance.

In conclusion, Ngo stated, risk budgeting is:

1. understanding the risk created by your strategic asset allocation position (beta risk);
2. your active management decision entailed by your choice of managers (alpha risk);
3. how the alpha and beta risk come together to generate your total portfolio risk and volatility; and
4. assuming you were to optimize—is there a better solution?