Risk Parity: Investors' concerns about a rising interest rate environment are misplaced

Risk Parity strategies have delivered strong risk-adjusted returns in the recent years of uncertainty, but some investors are concerned about the effect on them of possible interest rate rises. A recent paper from Aquila Capital, one of Europe's leading alternative investment managers, "*To Bond Or Not To Bond, That Is The Question"* suggests that these concerns are overblown*.* The study's authors, Harold Heuschmidt and Dr. Torsten von Bartenwerffer evaluate the effects of interest rate developments on the performance both of bonds and Risk Parity strategies. This follows Aquila's recent Europe-wide survey of 255 institutional investors, in which 60% of respondents raised questions about the possible effects of interest rate rises on Risk Parity portfolios. Certainly, bonds are an important component of Risk Parity strategies, which exploit the diversification benefits of allocating capital across a range of uncorrelated asset classes, with each asset class contributing equally to the overall risk of the portfolio. The basic principle is that if some asset classes fall, others compensate by rising.

Aquila Capital's paper examines how a Risk Parity portfolio would have performed in three testing market environments: the Great Depression, the inflationary period of the 1970s and the bond market drawdowns between 2005-2008. The conclusion is that Risk Parity strategies can deliver attractive risk-adjusted returns across different types of market uncertainty, including periods of rising interest rates.

The study shows that if interest rates remain low or fall further, bonds are likely to make a positive contribution to performance. If rates rise, then bonds would still pay off if such rate hikes have already been priced into the relevant forward curves and the yield curve has a sufficient slope, as currently seems to be the case. If rates rise as a result of strong economic growth or inflation and there is a fall in bond prices that is not matched by yields, then there is likely to be a compensating rise in other asset classes (equities and commodities) within Aquila's Risk Parity portfolios.

Periods of bond market drawdown tend to be shorter and less dramatic, in any case, than many investors believe. For example, following an unexpected upward shift in rates in 1994, the worst calendar year for the broad bond market, the fall was 2.9% (the following year saw gains of 18.5%). On the other hand, in 2008, the S&P 500 fell by more than 2.9% on 27 individual trading days.

The paper emphasises that managing bond risk is also a matter of diversification within the uncorrelated asset classes in which the Risk Parity strategy is invested. The Aquila Capital approach is to diversify across a broad range of bond markets on an equally weighted basis. The yield curve, different parts of which respond differently to rising rates, is then dissected in order to ensure a suitably diversified exposure to a range of bond maturities.

The authors also observe that it is uncertain whether rates will actually rise. The current environment of widespread deleveraging, accompanied by both demographic and regulatory pressures that are channelling savings and institutional balance sheets into bonds, could mean that rates remain stable or actually fall. In any case, Mr. Heuschmidt and Dr. von Bartenwerffer conclude that interest rate rises, if they occur, are unlikely to impair the ability of well managed Risk Parity strategies to continue to deliver the strong risk-adjusted returns of recent years.

Stuart MacDonald, Managing Director at Aquila Capital said:
"There is a growing recognition of the value of Risk Parity strategies as an essential part of a well-constructed portfolio. Many investors, however, have not yet grasped the way in which Risk Parity can perform in different market conditions. The challenge is to build greater awareness of the diversification and risk equalisation concepts that support Risk Parity. Risk Parity strategies can combine highly controlled volatility and truly effective diversification with high levels of liquidity, transparency and scalability, without compromising returns.

Risk Parity strategies have proven themselves through the different phases of market uncertainty, both before, during and since the Crisis. Aquila was one of the first investment managers to identify *the opportunities in Risk Parity and our Risk Parity strategies - both through the AC Risk Parity 7, 12 or 17 funds or through Aquila's ability to provide customised Risk Parity solutions - have consistently delivered strong risk-adjusted returns since 2004. This includes, for example, strong positive returns in 2008."*

Notes to editors
Contact:

Alexa Kurschinski
Aquila Capital
+49 40 87 50 50 175
alexa.kurschinski@aquila-capital.de

Byron Ousey / Madeleine Palmstierna
Kreab Gavin Anderson
+44 (0)20 7074 1800
aquila@kreabgavinanderson.com

About Aquila Capital

Aquila Capital is one of Europe's leading independent Alternative Investment managers with over USD 5.3billion in assets under management. The company specialises in the management of market independent investment strategies that are driven by global macro trends and which provide strong risk-adjusted returns. Founded in 2001, Aquila Capital is part of the Aquila Group, with a network of offices across Europe and Asia.

Further information can be found at www.aquila-capital.com.