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Risk Control Through Dynamic Core-Satellite Portfolios of ETFs: *Applications to Absolute Return Funds and Tactical Asset Allocation*

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Abstract

Asset managers generally focus on diversification or returns prediction to create added value in portfolios of exchange-traded funds (ETFs). This article discusses dynamic risk budgeting techniques to emphasize the importance of risk management when decisions to allocate to ETFs are made. Absolute return funds, in which the low-risk profiles of government-bond ETFs and conditional allocations to riskier equity ETFs can be combined to obtain portfolios that—beyond the natural diversification between stocks and bonds—provide upside potential while protecting investors from downside risk, are an initial application of ETFs to allocation decisions. A second application is risk control of tactical strategies. Dynamic risk budgeting is used to

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provide risk-controlled exposure—taking the manager’s forecasts as a given—to an asset class. This article shows that, even if the manager is an excellent forecaster, this approach yields intra-horizon and end-of-horizon risk-control benefits considerably greater than those of standard tactical asset allocation.

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