Financial Analysts Journal ›
Volume 68, 2012 - Issue 1

Portfolio Management

Leverage Aversion and Risk Parity

Clifford S. Asness, Andrea Frazzini & Lasse H. Pedersen

Pages 47-59 | Published online: 30 Dec 2018

Cite this article https://doi.org/10.2469/faj.v68.n1.1

Abstra

The auth … n portfolio theory: … ets. Consum … creating an opportu … olios exploit this opp … over

In our ar … odern portfolio … returns than riskier a … skier assets to achie … sets and reducing … relatively low dem … djusted

returns offered by safer assets requires leverage, which creates an opportunity for investors with the ability and willingness to apply leverage.

A risk parity (RP) portfolio exploits the high risk-adjusted returns of safer assets in a simple way—namely, by equalizing the risk allocation across asset classes and thus overweighting safer assets and underweighting riskier assets relative to their weights in the market portfolio. Although an unleveraged RP portfolio has a lower risk than the market portfolio (and the 60/40 portfolio) owing to the higher allocation to safer assets, the RP portfolio can be leveraged to achieve the same risk as the market portfolio and a higher expected return.

Consistent with our theory of leverage aversion, we found empirically that risk parity has outperformed the market over the last century by a statistically and economically significant amount. Indeed, in the United States, an RP portfolio with the same risk as the market portfolio outperformed the market portfolio by about 4 percent a year over 1926–2010. Furthermore, the RP portfolio delivered higher risk-adjusted returns than the 60/40 portfolio in each of the 11 countries covered by the J.P. Morgan Global Government Bond Index over 1986–2010. We performed extensive robustness tests and analyzed the related evidence across and within countries and asset classes.

Editor's Note: The authors are affiliated with AQR Capital Management, LLC, which offers ris

Relat