Private Market Insights

A NEWSLETTER BY FAST

Risk-Based Diversification and a Focus on Alpha: How to Optimize Portfolios Utilizing Private Markets

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In last month's AccessAres *Private Market Insights* newsletter, the Financial Advisor Solutions Team ("FAST") championed a New Moderate Model Portfolio with a 50% allocation to private markets. As part of this, we also discussed how advisors can help their clients achieve different objectives by utilizing the same overall allocation to private markets of ~50% and shifting between private market asset classes. You can read more in "**Out with the Old and in with the New**."

Our in-house New Moderate Model Portfolio was built using a differentiated approach to asset allocation: risk-based diversification. We believe risk-based diversification (also referred to as "factor risk budgeting") is key to building more effective portfolios utilizing private markets and unlocking wealth creation.

In this month's edition, we unpack the concept of risk-based diversification and why it continues to become more popular among institutional investors and financial advisors. We also discuss how advisors can adopt this approach for their own practices, using our in-house New Moderate Model Portfolio as a frame of reference.

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The trouble with asset classes

When utilizing traditional portfolio construction optimization methods (otherwise known as “mean variance optimization”), investors typically run into two main roadblocks:

1. **High sensitivity to the accuracy of risk/return forecasts.** Making even the slightest changes to your assumptions can potentially lead to significant differences in what an “optimal” portfolio looks like.
2. **Asset class constraints.** Because the traditional optimizer will tend to push all the allocation to the most efficient asset classes like private markets, large constraints are often required to get a “reasonable-looking” portfolio. Choosing these artificial constraints largely predetermines the outcome.

As a result of these challenges, many CIOs and multi-asset portfolio managers agree that mean variance optimization is largely unhelpful in today’s investing world. In fact, many institutional investors with a meaningful allocation to private markets have moved away from these techniques and have embraced a risk-based approach to constructing portfolios.

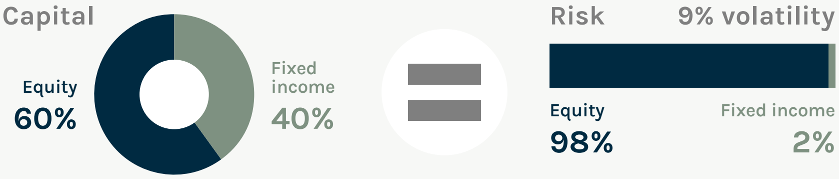
This method is called **factor-based risk budgeting.**

Factor-based risk budgeting

To understand why we use factor-based risk budgeting, we first explain a perennial trouble that plagues portfolios.

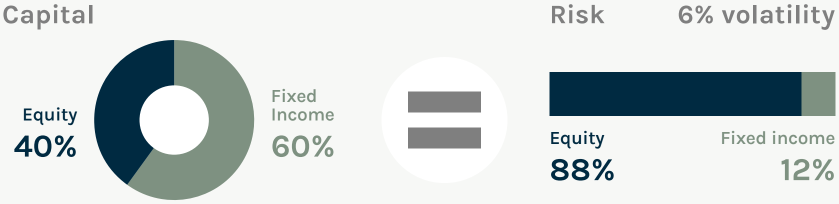
Many investors are aware that almost all of a typical portfolio's risk is driven by the risky portion in equity, and not by the fixed income.

Traditional 60/40 portfolio



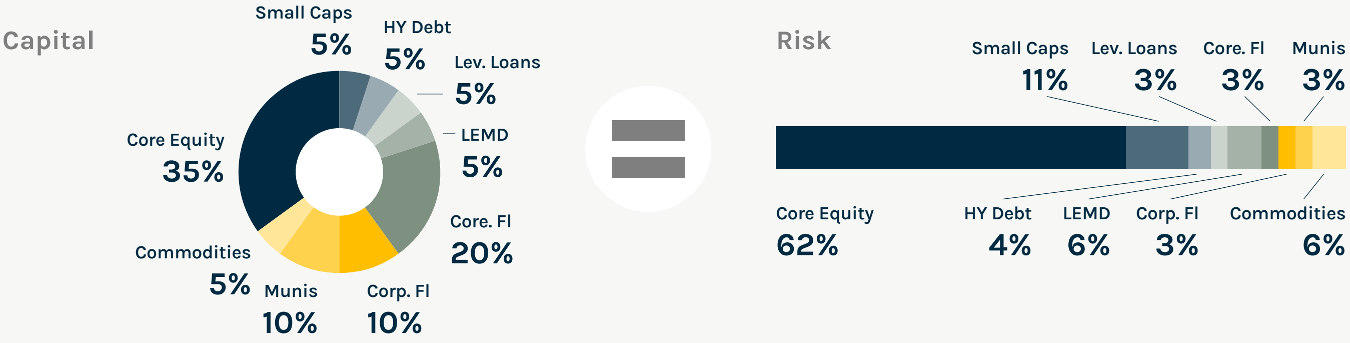
Many investors are also aware that even in a relatively conservative portfolio with 40% core equity and 60% core fixed income, most of the ups and downs that the portfolio may experience are still driven by the smaller core equity allocation.[1]

Example: "conservative" portfolio

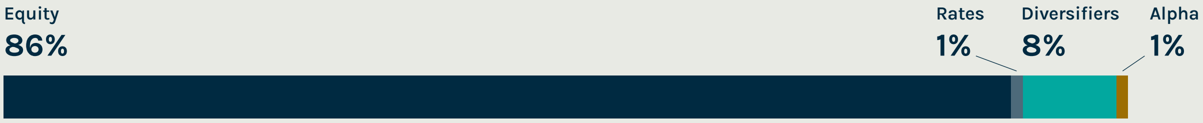


As a result, many thoughtful investors have moved toward much more diversified portfolios, which might look something like this:[2]

Example: "diversified" portfolio



However, this more diversified-looking risk allocation can hide an uncomfortable underlying truth. After asset class-specific risks are fully diversified away, what is left is a set of risks that describe the true drivers of return of *any* asset class. We call each of these a "risk factor." A risk factor represents a fundamental and independent driver of portfolio return. We show the underlying risk factors of the example here:



1. Public equity represented by MSCI ACWI NTR; public fixed income represented by Bloomberg 7–10-year government bond index. Diversification does not ensure profit or protect against loss.
2. The investment sectors above are represented by the following indices: High Yield Debt—Bloomberg Barclays Global HY Corp; Small Caps—MSCI World Small Cap; Leveraged Loans—Credit Suisse Leveraged Loan Index, LEMD- Bloomberg Barclays Emerging Markets Aggregate Index, Core FI- Bloomberg Global Agg Credit, Corp FI- Bloomberg US Corp IG, Munis- Bloomberg Municipal Bond Index, Commodities- Dow Jones Commodity Index, Core equity- MSCI ACWI

As the above example illustrates, many of the asset classes outside of core equity are still driven by core equity risk factors. It is not surprising that the way small caps or emerging market equity perform will be closely tied to how core equity performs. But even the risk of a fixed-income asset class may be partially influenced by what happens in the equity markets—for example, more than a third of high yield's ups and downs are driven by the same factors that impact core equity!

Examining a portfolio through a factor lens may reveal overlapping sources of risk across asset classes. We believe that this allows for more efficient management of portfolio risk and expected return.

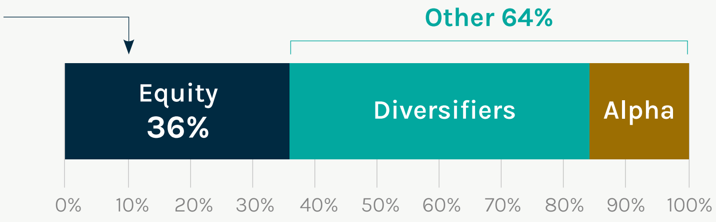
Example

High yield is often used to diversify against equity

But...

Nearly 40% of its risk is equity itself!

High-yield bond risk factors

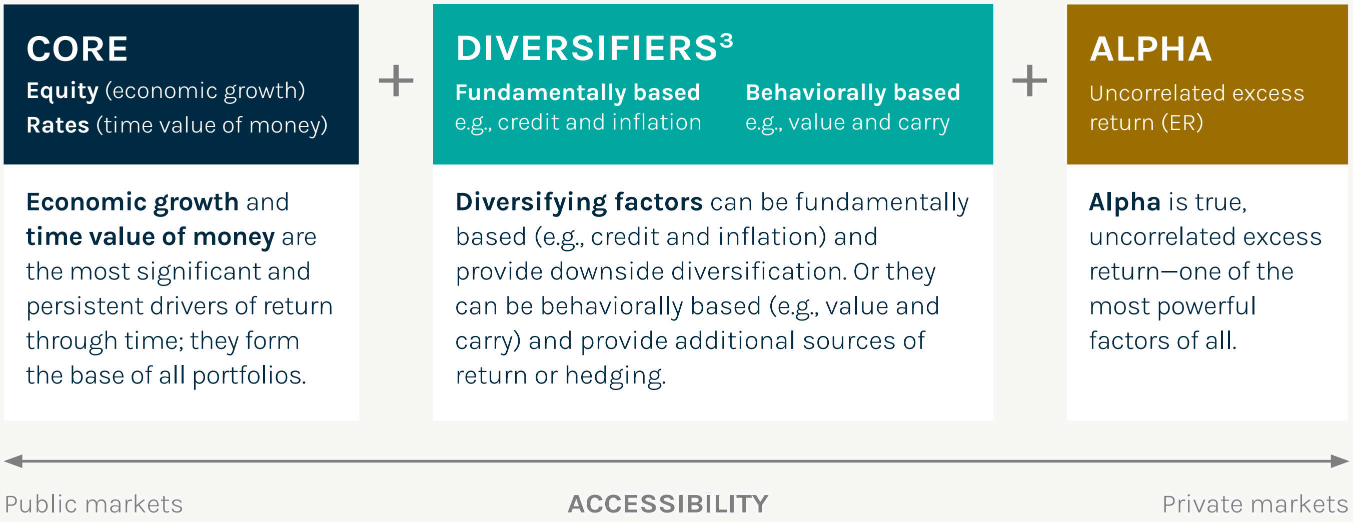


See next page for additional information on risk factor definitions.

Factor this into your approach

To understand what is really going on underneath the hood of a portfolio, we look at factors. At AWMS, we prefer to use a simple set of risk factors that we believe intuitively describes as much of a portfolio's risk and return as possible. The Financial Advisor Solutions Team organizes those factors into a few basic categories:

A risk factor represents a fundamental and independent driver of portfolio return:



CORE

Equity (economic growth)

Rates (time value of money)

Economic growth and **time value of money** are the most significant and persistent drivers of return through time; they form the base of all portfolios.

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DIVERSIFIERS[3]

Fundamentally based e.g., credit and inflation

Behaviorally based e.g., value and carry

Diversifying factors can be fundamentally based (e.g., credit and inflation) and provide downside diversification. Or they can be behaviorally based (e.g., value and carry) and provide additional sources of return or hedging.

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ALPHA

Uncorrelated excess return (ER)

Alpha is true, uncorrelated excess return—one of the most powerful factors of all.

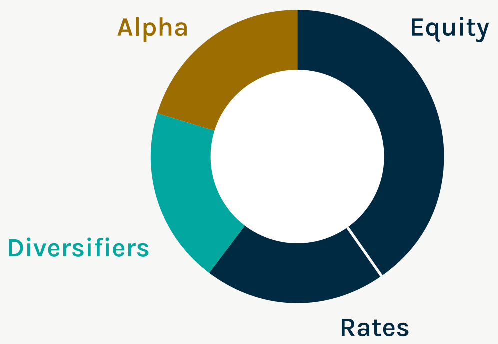
[3] Diversification does not ensure profit or protect against market loss.

Importantly for portfolio construction, every factor, similar to an asset class, has a corresponding assumed return, risk and correlation. Conveniently, these assumptions are more stable than asset class-specific assumptions. Balancing risk factors can help ensure diversified risk and avoid unintentional concentrations—most often in equity, as previously noted.

To translate this into practice and build out a portfolio, we start by building a diversified risk budget of these factors. The factor risk budget is subjective and based on an investor's view of the world. For example, based on various assumptions and beliefs as part of Ares, the framework for our risk budget is as follows:

- **Equity** (global growth) and **rates** (time value of money) underpin large portions of the investing world and therefore form our two **foundational** factors.
- We view **credit, commodities** and **inflation** as **protection** for bad things that can happen—**not fundamental return drivers**, but marginal protection. Investors who are more sensitive to downturns may want slightly more of these factors.
- **Equity style** factors and **alternative risk premia** offer nice **diversification**, and we layer them in accordingly.
- Finally, we include **alpha** at roughly equal weighting to the diversifiers and rates.

Factor Portfolio

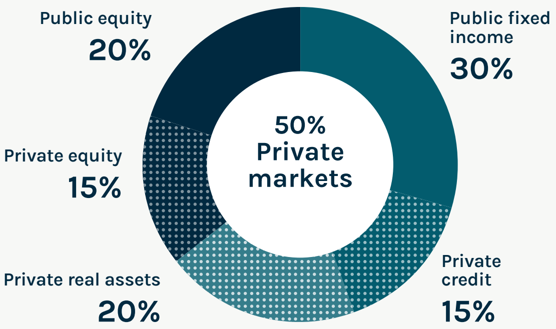


Once we have our factor risk budget in place (see Factor Portfolio above), it becomes a relatively easy exercise to work our way forward into our asset class allocation (by setting our optimizer to find the most capital-efficient way to fill in asset classes, given the constraint of our factor risk budget). The practical outcome of this process, utilizing the set of risk factors above and our in-house factor risk budget, is a portfolio with 50% allocation to private markets—our New Moderate Model Portfolio.

Compared to a traditional 60/40 portfolio, the 50% private markets portfolio has:[4]

- ~50% higher return
- Nearly double the yield
- Two-thirds the drawdown (we should note here that max drawdown is our preferred measure of risk since it fairly reflects the smoothing bias of private markets)
- Half the underlying risk from core equity

New Moderate Model Portfolio



All of this combined means that the New Moderate Model Portfolio is **2x more efficient** (as given by a Sharpe ratio) than a traditional 60/40 portfolio. **More efficiency in the portfolio should mean more controlled outcomes for you and your clients.** In addition, it becomes easy to create "Growth" and "Growth & Income" variants of this portfolio for different goals-based investors.

[4] **Based on a hypothetical portfolio over a 20-year time period using index returns.** Public equity represented by MSCI ACWI NTR; public fixed income represented by Bloomberg 7-10-year government bond index. Private equity represented by Burgiss Buyout index. Private credit represented by Burgiss 1L index. Real assets represented by a 50/50 split of Burgiss Infrastructure index and NCREIF-NFI ODCE real estate index. Historical performance March 2002-March 2023. Past performance is no guarantee of future returns.

Optimizing the use of private markets

Optimizing for risk and return ("mean-variance optimization") has always been a tricky prospect. The difficulty of accurately predicting forward returns and risks, together with the high sensitivity to these assumptions and the common outputs that call for extremely high allocations to relatively efficient asset classes like private markets, has frustrated practitioners for decades. In our experience, factor risk budgeting limits arbitrary constraints for the CIO and investment committee. Factor risk budgeting also tends to work well with the "Endowment Model" pioneered by David Swensen at Yale, lending science to the intuitions that back the popular private-markets-heavy approach.

To learn more about the model portfolios that we as a team derive from our factor risk budgets, including weights, please see "**Out with the Old, In with the New**" in last month's edition of the AccessAres *Private Markets Insights* newsletter, as well as our recent FAST Take blog post. For more information on additional FAST resources, including educational webinars for CE credits and 1:1 consultation, please reach out to your primary AWMS contact or email **AWMS@aresmgmt.com**.

About the Financial Advisor Solutions Team (FAST)

FAST offers resources and one-on-one support to help navigate the complexities of private markets investing. The team's goal is to empower investors to confidently incorporate private markets investments into portfolios. The educational content, research and analytics that FAST delivers are designed to enhance the understanding of the benefits of private markets investments. FAST is a skilled and knowledgeable team of professionals who can answer questions and foster more informed decisions.

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Disclosures:

Investing in private markets involves risk, including the loss of principal. Other risks include but are not limited to illiquidity risk, valuation risks and a number of other risks related to private companies in general.

Financial advisors must carefully consider the risks and other suitability details in determining appropriate investments for their individual clients' portfolios.

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