The ReSolve Master Class – Episode Ten

Mike: **00:00:00** Welcome to Episode 10 of the Master Class series. We're going to try and put it all together for you in this last episode. And initially, we want to go back to the why, at the very beginning. Why is it important to think so deeply about this issue? The reality is that we have, remember those asset owners, those long lived asset owners that are managing or have assets that they know are going to live well beyond their time on this planet, in this universe. Being aware of that means they also know that those assets will encounter all of the economic regimes over time, there is going to be a period where those assets experienced a stagflationary period. So when you think about this over multi decade periods of time, you really have to think about, okay, how am I going to be prepared for that? And then if I'm going to be active about anything, how am I going to think about prediction or adding value to that portfolio? And then lastly, when all else fails, when we have a massive liquidity crunch, how else might I think about preserving my wealth in that inevitable potential earthquake in financial markets? So we've talked long and hard about that. Now, probably, it's time to talk about how.

Rodrigo: **00:01:13** The assembly instructions.

Adam: **00:01:16** That's right. This is where the rubber hits the road. We start with a risk parity portfolio, global risk parity, the futures markets offer the greatest diversity of liquid instruments that you're likely to find anywhere in terms of getting exposure to all of the major economic risks and sources of return that are available in markets. The other great thing about futures is that they provide for inexpensive leverage. Let's go back and talk about a traditional portfolio or how most investors think about this problem. You've got a set of liabilities, maybe it's retirement, maybe it's plan beneficiaries that you need to sustain funding for over many many decades. And this required return exceeds the risk free rate.

So you can't just invest it all in cash or Treasury Bonds and achieve the return you need. You've got to go out the risk curve. And most investors, and this includes institutions and individuals, they go out the risk curve by sacrificing diversity, they move away from bonds into concentrated positions in equities. And for some institutions and high net worth investors that includes stuff like private equity, private credit, by moving out that risk curve, it's worth noting that you're also adding leverage to the portfolio. Because for example, the S&P 500 has about two to one leverage based on the debt to equity on the weighted average book value of S&P 500 firms. Private equity firms take out an enormous amount of leverage in order to boost the returns to the funds and therefore the performance bonuses to the GPS.

Rodrigo: **00:02:51** Not to mention private real estate.

Adam: **00:02:53** Private real estate, exactly same thing. So that's one way to reduce your required returns. Just push out the risk curve into concentrated exposures to equities or equity like assets, that are expected to perform well during periods of strong economic growth, benign inflation and abundant liquidity conditions. The alternative is what we've been advocating for, which is create a portfolio with maximally diverse assets that are resilient to all four major economic regimes defined by shocks to inflation and growth, ensure that they are in ideal balance or harmony with one another, they're all able to express their unique personalities in the portfolio. So they're tightly integrated. And once you've built this resilient portfolio, you may be able to find other edges, maybe widely available commoditized inexpensive edges, like all style premia, or factor exposures.

And then, moving further out the complexity curve or the sophistication curve into maybe legitimate alpha sources, opportunistic, more complex alpha strategies, that sort of thing. Layering on maybe a tail hedge. With futures, you're able to create this maximum diversified portfolio, you're able to lever that portfolio to whatever risk that you need in order to achieve your required return. And you're able to do that with the cheapest leverage around because the leverage and futures markets is priced at the margin, so that the investors that have access to the cheapest leverage are the ones that are able to arbitrage the prices in the futures markets. So it's the cheapest leverage around, you've got cheap leverage diversity, and because of the leverage that you get from futures, a massive amount of excess collateral. So let's say you've got your diversified risk parity futures portfolio, you're levered to a 10 or 12% annualized volatility to hit your required return. Maybe you require 30, 35% margin on that maintenance margin. Maybe, on that if you're being conservative. Well, that means you've got 50, 60 cents on the dollar that you can allocate to other diversifiers, whether it's factor funds, alpha sources, timberland, infrastructure, etc.

The point is you're making maximally efficient use of capital to diversify your portfolio to achieve your required return targets, rather than concentrating in equity risk and being vulnerable to at least two out of four potential economic regimes that you're going to experience along the way over the many decades that your portfolio is invested.

Rodrigo: **00:05:35** I think we would gravitate towards those alternative areas that actually add a unique bet so that diversification dampens your volatility. You don't want to just grab your risk parity portfolio and put more private equity, private real estate, VC investing, more leverage...

Adam: **00:05:52** These are just equity bets, exactly. If you're just concentrating in equities again,

Rodrigo: **00:05:55** If you had, let's say, a well diversified risk parity portfolio with 13 unique bets on average, you're staying with 13 bets. Actually, you're getting lower bets, because you're concentrating. So the key here is, use that capital and find true idiosyncratic risks that you can add to the portfolio to continue to keep your portfolio in balance, and not really get out of whack in terms of the risk scale.

Adam: **00:06:17** And ideally, if you're a very large institution, sophisticated institution, ideally, you can do all this yourself internally. Or a great proportion of it, 80, 90% maybe. The benefit of that is that you're able to directly integrate all of the existing bets and take advantage of the netting effects. For example, let's just take some macro funds, for example, maybe one macro fund’s running a trend strategy and other macro fund’s running a carry strategy. They're both running it on the same futures universe. Well, if you hold two funds, you're going to have lots of situations where one fund is buying a market and the other fund is selling a market on the same day. If you run them as an integrated strategy, those two trades net and you're carving your amount of trading and therefore the trading costs, execution, slippage, etc., all down dramatically.

Now, expand that out to 5, 6, 10, 12 different unique bets and the netting opportunity from all of those independent strategies, and you're really talking a substantial amount of savings. And there's some good papers that help to quantify the savings, but it's very material. And, you're able to manage the risk very directly because you can see through to all of the different dimensions of the portfolio and see where your risk exposures are and very directly seek to plug those holes.

Rodrigo: **00:07:35** In order to do that it does require a level of technical sophistication within the team that understands how to manage a separately managed account and integrate signals from other managers. Again, when you say that they can integrate it themselves, I believe you're saying that they can, if they have the expertise in house to run these strategies, they can do it in an integrated manner. Or they can hire out third party managers to run separately management accounts if they have the platform, the expertise to be able to benefit from carving out those trades.

Adam: **00:08:03** Yeah, an outsourced CIO who's able to run a strategy like that is equally effective.

Rodrigo: **00:08:07** Yeah, you can outsource that expertise. And then, there are those managers that still have the ability to create and have a futures based beta portfolio and still buy with cash the cash that they have traditional fund…

Adam: **00:08:20** **...**to you to purchase funds, 100%.

Rodrigo: **00:08:22** That's right. So there's many ways that an institution, we've seen institutions integrate these types of approaches using leverage and using futures and swaps and other derivatives, that not enough institutions are taking advantage of.

Adam: **00:08:36** We still to this day, if you look across the reports on asset allocation across endowments, foundations, corporate and public pension plans, and insurance companies, they are still sticking to very traditional, basically equity loaded asset allocations in order to hit their required returns. So they're sacrificing diversity for concentration due to leverage aversion. Some of that leverage aversion is due to legitimate regulatory or governance constraints. Those regulatory and governance constraints work directly against investors' ability to get into a resilient portfolio that is designed to weather the ups and downs over the decades from different economic regimes so that you're not doing investors any favors where you have the power to nudge Boards into allowing more progressive strategies that incorporate reasonable amounts of leverage. I think that is a worthwhile governance action.

Rodrigo: **00:09:34** A lot of it often has to do with the fact that you were advocating the beta side of the portfolio to be held in derivative instruments. The other way to do this is to actually hold your beta portfolio in cash assets. We've been doing it for five years internally and ultra high net worth individuals and some foundations, where we run separately managed accounts, fully paid up and exchange traded funds, and you can see the results, you can actually create a pretty fantastic risk parity portfolio using that.

Adam: **00:10:05** I think the benefit for that though is narrowly for high net worth investors who have large stock positions that they can use for collateral against diversifying strategies that are financing features positions.

Rodrigo: **00:10:21** That's right.

Mike: **00:10:22** That's one. But you have a continuum of investors that are encountering this 10 step, or 10 series Master Class who are going to have different comfort levels with the various implementations. If you're part of an Investment Board and they're fully against leverage, they're not able to do that, then there is an expression of risk parity that you can do with ETFs. It works quite well; it faces all the challenges we talked about in the episode on preparedness. You're going to have a nice Sharpe ratio and it's going to be low risk and low return. And that's okay. That's where you're ready to take the step. That's where we would advocate for taking step thinking, about how you might add the alternatives to that in order to provide excess returns and what have you, or provide further diversity.

Rodrigo:	**00:11:07**	We run them as well. This idea of cash paid up and then we implement the portable alpha or the long/short futures. On top of that using the cash securities as collateral. So that way, it's just a different approach that has a different level of comfort. I would say that I've had certain conversations with institutions that would prefer that step before the one that you mentioned, I think optimality and comfort are two different things.
Adam:	**00:11:35**	The benefit of implementing your beta with futures is that you're taking advantage of the cheapest available leverage.
Rodrigo:	**00:11:40**	100%.
Adam:	**00:11:40**	Otherwise, you're posting collateral and you're using broker margin, and the broker margin is not going to be as cheap as the leverage.
Rodrigo:	**00:11:47**	Not if you're using futures overlay, if you're active alpha is using futures and swaps and you don't necessarily...
Adam:	**00:11:54**	Agree. Yes. If you're layering over futures, then yes. Either way you're using futures.
Rodrigo:	**00:11:57**	If you're borrowing in order to buy units of funds for their sell premium or other hedge funds, then yes. You're certainly going to take in a bigger cost that you don't need to. But again, it's all a spectrum and it all depends on the personality of the boards, the foundations of the individual.
Adam:	**00:12:10**	Structural funds, and existing investments and stuff.
Rodrigo:	**00:12:13**	And of course, then we get to the individuals. And we know that there's a lot of individuals that can do this podcast, it used to be a lot tougher to be able to put together a portfolio or find instruments to put together a portfolio like the one we've described, but today, 10 years after exchange traded funds, and then the regulatory rules with allowing certain active management, you can actually find strategies, funds, ETFs that do a lot of this already.
Adam:	**00:12:38**	There are total solutions that implement the full spectrum of the ideas that we discussed throughout the Master Class program.
Mike:	**00:12:44**	That's right. It shouldn't be underestimated the opportunity that the integration piece plays, integrating all the way through the process, the asset classes that thrive in the different economic regimes. And then taking that portfolio and finding the alphas excess returns, other returns that are unlike those returns that complement that and integrate that. And then further integrating the tail protection into that, and into a number of different ways throughout the

portfolios Adam discussed in the actual tail protection strategy. That integration and that netting is tremendously powerful, and it has the rebalancing premium that we've written extensively about, is really harnessed to its maximum potential there. Whilst I do see institutions taking this on and some very sophisticated institutions do an extremely good job, this is not something to be trifled with. It really is an opportunity for expertise in excess risk adjusted returns. And so from our perspective, we also offer a couple of products that are either available through fund companies or exchange traded that harness all of that together and put it in a package that is fully integrated for use both for individual retail investors as well as small institutions that might want to try this in some way that complements the rest of their portfolio. It's absolutely crucial to understand that top to bottom, A to Z integration and netting throughout the portfolio and how powerful that is, as a force to creating risk adjusted returns.

Rodrigo: **00:14:19** I would echo that the rebalancing premium that we talked about in the paper was about rebalancing a risk parity portfolio. We've added a few more bets throughout this process. That rebalancing premium that doesn't require an actual positive rate of return in order to get access returns, is absolutely essential. And you could be leaving a lot of money on the table if you're not taking that into account as you put your pieces together. So if listeners want to put theory into practice, you can go to our website at investresolve.com. We have all the parts and we have the fully assembled options as well. So institutions generally like to be a bit more bespoke, most sophisticated. Institutions are able to do the rebalancing that they need, some individuals and small foundations don't. So we have this fully integrated beta alpha tail. They're ready for them at different volatility targets. We welcome any feedback and anybody that has any questions can come and communicate with us.

Mike: **00:15:19** Awesome. And remember, like and share, smash the like button even if that works on a podcast. I don't even know. Write a great comment on it. Share with other like-minded colleagues and professionals.

Adam: **00:15:30** Yeah. And feel free to challenge us if you have different views.

Mike: **00:15:33** All right, Well, I guess that's a wrap.

Rodrigo: **00:15:34** Excellent work gentlemen.

Adam: **00:15:35** Thanks very much.

Mike: **00:15:36** Cue the music.