Lombard Odier pushes risk parity approach to investing

Face to face

Hubert Keller tells **Sophia Grene** a focus on risk factors is the way of the future

Hubert Keller is more strongly motivated than most asset managers to think hard about risk. He is one of eight partners at Lombard Odier with unlimited liability, which means mismanaging risk could mean significant personal losses – a fact that tends to concentrate the mind.

Since the financial crisis, that concentration has redoubled as it became clear the investment environment had shifted long term, with no immediate return to the easy truisms of risk being rewarded, diversification across uncorrelated asset classes an obvious free lunch and economic growth a given over the medium term.

Instead asset managers have to work out how to live in a less investor-friendly world, where returns are likely to be lower and volatility higher.

"We believe very strongly that the asset management industry needs to reinvent itself from the risk perspective," says Mr Keller. "We need to move away from the approach that relies on capital market returns and move to something more risk-based."

One of the areas where the partners' unlimited liability could potentially bite is the firm's own pension fund. A defined benefit fund with a value of SFr1.05m ($1.1m), it used to be managed along traditional lines, with a strategic asset allocation aligned with the liabilities and a tactical asset allocation overlaid on this, all outsourced to external managers.

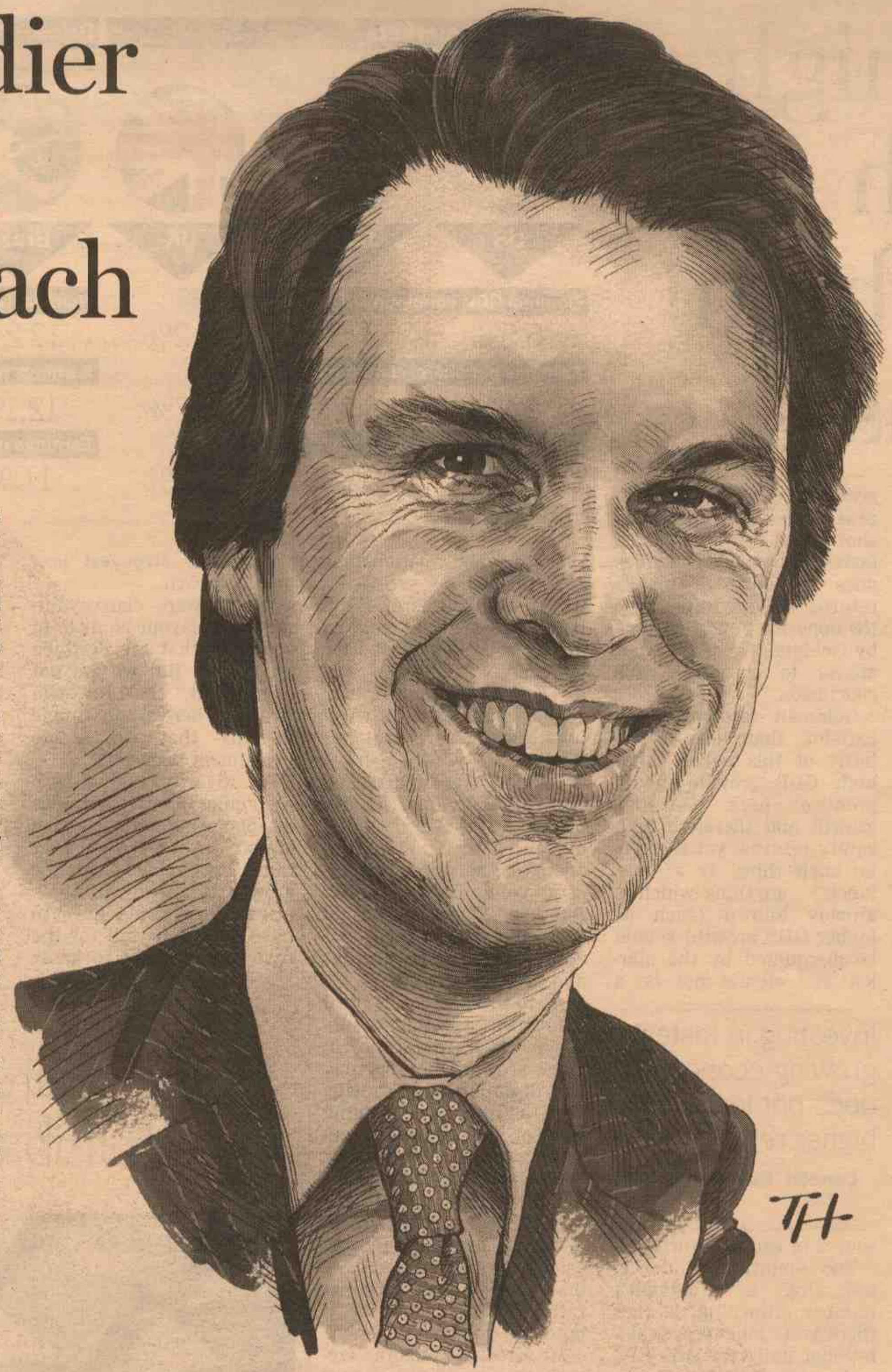
This implied three main drivers of returns, says Mr Keller: capital markets, manager skill (alpha) and tactical asset allocation or market timing. "When you work with a strategic asset allocation, the amount of tactical asset allocation you can do is relatively constrained," he points out, while manager alpha is difficult to find. When capital markets are looking likely to post lower returns than previously, the whole system has to be reassessed.

Lombard Odier's approach was twofold. The first decision was to "separate what's liquid from what's illiquid – you've got to be ruthless about it. Then decide how much of the portfolio can be illiquid."

For the Lombard Odier pension fund, around 30 per cent could be invested in illiquid assets, tied up for as much as 10 years.

The rest of the portfolio is then subject to a risk budget; "this becomes the thing we live by". Setting a risk budget entailed deciding what the drawdown budget would be, ie, how much could they live with losing, peak to trough, in a given year, and what volatility they could live with. These figures will be different for every investor or pension scheme, depending on their liabilities, their risk appetite, their investment horizon; in the case of Lombard Odier's pension fund, they decided the maximum drawdown they could live with was 8 per cent, with a volatility of 5.7 per cent.

'A lot of clients know that the strategic asset allocation model has issues'



Then allocations were decided by making sure each component of the portfolio – in this case, Swiss and global bonds and equities – made a roughly equal contribution to that risk. This has restored the funding ratio from its unacceptable low point (Mr Keller is vague but implies it fell below 100 per cent in 2008) to 101.7 per cent at the end of 2011, with volatility of 2.2 per cent.

The risk parity approach meant higher allocations to less risky assets such as bonds, so over the three years since this strategy was implemented, performance has been flattered by rallying bonds, admits Mr Keller.

Nevertheless, he is convinced this risk parity approach is appropriate for whatever market and economic scenario lies ahead, and Lombard Odier has evangelised this concept among its clients, in particular pension funds.

It can be a tricky sell, as it requires pension fund trustees to throw out the idea of a strategic benchmark, which they often cling to because it makes it relatively easy to assess progress and performance.

"They need to define their investment objective differently," says Mr Keller, suggesting an objective such as "cash plus 3 per cent" is more meaningful in a time of low stock market returns anyway.

However, even pension fund trustees are waking up to the fact that a new approach to investment may be indicated. "A lot of clients know the strategic asset allocation model has issues," says Mr Keller. "There are several alternatives, but they all have in common a risk allocation framework."

In its simplest form, this consists of risk parity implemented on traditional asset classes, as described for the Lombard Odier pension fund, but this is just a transitional phase, according to Mr Keller.

"Risk factors rather than asset classes; there's the way of the future."

This involves identifying the risk factors driving returns from investments. Danish pension fund ATP, which has implemented a risk parity approach for some years, uses five risk factors: interest rate risk, credit, equity, inflation and commodities.

For each investment strategy in the portfolio, "you have to think about the risk factors embedded in them", says Mr Keller, then make sure that each risk factor contributes the appropriate amount of risk to the overall portfolio.

Even this more sophisticated approach may not be the pinnacle of evolution for risk parity, he says, as "it will all evolve very quickly but I am absolutely convinced this is the future of the industry".

This is good news for relatively small, focused asset managers such as Lombard Odier, but will "pose huge problems for the big asset managers because they're not organised that way", according to Mr Keller.

Curriculum vitae

Hubert Keller

Born
1967

Education
1989
Haute Etudes Commerciale (HEC), University of Lausanne (Economics degree)

Career
1989
Compagnie Financière Tradition (treasury group)

1991
SG Warburg (investment banking group)

1995
Global co-head of equity capital markets and member of the global banking executive, Deutsche Bank

2005
Managing partner (one of eight, with unlimited liability), co-head of Lombard Odier Investment Managers

Lombard Odier

Established
1796

Assets under management
$164bn (30 June 2012)

Number of employees
1900

Head office
Geneva

Ownership
Partnership – 8 partners with unlimited liability