# A better approach to risk allocation

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COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

The benefit of an active risk allocation approach over a static risk allocation approach is that we will seek to participate more in the upside when markets are doing well. And we will be seeking to protect against the downside when markets are struggling.

When people think about risk allocation, most people take a static approach. We're saying that there's going to be different periods of time, where we might actually want to deviate from that.

When designing an adaptive risk allocation approach, it starts with identifying what the market state is. We consider four different market states. Most of the time, the world is in what we call the **neutral market state**. That's going to be a time where we expect generally similar risk adjusted returns for all different markets but we favor a more typical static risk allocation approach. However, there also times where we believe investors will benefit from having more risky assets in their portfolio. One of those states is called "the **bullish market state**". That's going to be a time where investors should start tilting their portfolio more towards things like equity, credit markets, other assets that generally behave like risk-on assets. In rare moments. We also identify what is called "a **highly bullish market state**", in which investors should take an even more decisive stance on having risky assets in their portfolio over things like Treasuries.

The fourth market state is what we call "the **capital preservation market state**". This is a state which is very important for downside protection. This is going to be the state where we suggest that investors take the highest exposure to things like treasuries and the lowest possible exposure to things like equities or other risky assets.

When I think about what it means to be adaptive versus tactical in a portfolio, a big element of that comes down to how systematic we're going to be. The way that we think about it is, we designed a series of rules to determine which of the different market states that we're in. It's not based on a feeling that I might have in the morning or any of my colleagues might have. It's based on a series of objective indicators that we look at that tell us which of the different market states we're going to be in. And what actually happens is that not only does that result in a suggested portfolio, but the entire benchmark changes as we look at those different market states. That's a key difference from a tactical approach, which might be based on a more qualitative view as investors are trying to shift portfolios.

When we set out to design our market state identification approach, we deliberately wanted to choose a small number of factors, but we wanted to choose factors that have a strong amount of academic research to support them. We look at equity factors, such as **momentum**, **volatility**, and **valuation** to determine whether or not we are getting a positive market indication or whether or not we're getting a more neutral market indication on the fixed income side. We look at factors such as **real yield** and a **yield curve factor** to determine whether or not the bond market is signaling at times are normal, or if there's a dislocation at play. And by looking at that combination of equity signals and fixed income signals, we're able to determine which of the four different market states that we're in.

Our neutral market state is not what other investors might even call a risk parity portfolio. This is why we're very careful to describe our strategy as risk allocation, instead of risk parity. The way that we've defined it is: half the risk is going to be coming from equity and half the risk is going to be coming from non-equity asset classes. Within those non-equity asset

classes, we try to have an equal contribution from a rates bucket, from a credit bucket, as well as from an inflation thematic bucket.

What that means is that we're going to have typically a higher equity weight than some of our competitors might have. But what that means also is that we need to take a lot less leverage in the portfolio because equity has such a high volatility and approach, which favors equity more in the portfolio design, means that we need to take less leverage when we're designing it.

We believe in diversification. We believe in taking more exposure to asset classes, which might have a higher risk-adjusted return in order to have a higher overall risk-adjusted return for a portfolio. But where we do differ is that we believe that by taking a systematic approach and by being adaptive, and reacting to different market states, we can improve the experience even more for an investor.

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There is no guarantee that the investment objective will be achieved or that return expectations will be met.

**Market state classification**: The management team employs quantitative and fundamental methods to identify four distinct market environments, described as neutral, capital preservation, bullish and highly bullish. The market states are generally characterized by a combination of bond and stock market conditions as follows: capital preservation (unfavorable bond market and neutral stock market conditions), neutral (neutral bond and stock market conditions), bullish (neutral bond market and favorable stock market conditions) and highly bullish (unfavorable bond market and favorable stock market conditions). A strategic risk allocation is created for each environment by analyzing multiple market indicators such as interest rates, inflation measures, yield curve, momentum, volatility and valuations. The different allocations will include exposure to equity securities, inflation-hedging assets and fixed-income securities, consisting of rate assets (generally, fixed-income securities issued by governments) and spread assets (other fixed-income securities). The neutral market state represents the environment that the management team expects to be in the most frequently and under normal circumstances. In this state they intend to balance risk between equities and three other risk sources: interest rates, inflation-hedging and spread assets. Within the other market states, the management team may increase or decrease the risk exposure to certain asset classes with the goal of generating attractive risk-adjusted returns and minimizing drawdown in that environment. Allocations of risk to asset classes may differ significantly across market environments.

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A “drawdown” refers to a decline in the value of an investment or portfolio.

“Leverage” refers to market exposure in excess of assets.

Diversification does not assure a profit or protect against loss.

Asset allocation does not assure a profit or protect against loss.

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