Most institutional investors, consultants and others in the investment management industry approach asset allocation in a similar manner. First, the optimal allocation to each broad asset class is determined, typically by using a mean-variance optimization process. Once the optimal allocation is determined, some combination of active and passive management is implemented in order to allocate investments to each asset class.

An alternative approach is to characterize an investment strategy in terms of systematic and active exposures. In this context, systematic return refers to the gain associated with exposure to a market-wide factor, such as the risk premium associated with investing in stocks or the default premium associated with investing in risky, fixed income securities.

The active component refers to the incremental risk and return that results from the use of strategies that are not associated with systematic exposure to market-wide factors. Examples of such risk include the residual risk in a 20-stock portfolio or the risk of rapidly changing the asset mix in a tactical-asset allocation strategy. Both of these examples represent risk-and-return profiles that cannot be explained by passive exposure to one or more systematic market factors.

Usual sources of systematic risk exposure include broad equity market exposure, exposure to the book-to-price or ‘value’ factor, as well as market capitalization, interest rates and default risk. Exposure to these systematic factors can be estimated using historical return data, analysis of portfolio holdings, or a combination of both of these methods.

This approach to risk allocation has several advantages. For one, the risk associated with active management is directly incorporated into the portfolio selection process. This gives institutional investors a greater degree of freedom when evaluating and implementing portfolio alternatives. By effectively relaxing the unintended constraints generated by the conventional two-step process, fund managers can create portfolios that are more efficient in a mean-variance sense.

By evaluating the rewards for bearing systematic risk with the incremental return and risk associated with active management, risk budgets can easily be used to control the overall mix of active and systematic risk in the portfolio. This allows for a more accurate use of so-called alternative investment strategies that often have exposure to multiple risk factors as well as higher amounts of active risk. It is important to note, though, that within this framework, hedge funds are not treated as an asset class, but rather a combination of systematic and active risks.

The framework explicitly allows derivative securities to be used to adjust systematic market exposure directly into the portfolio construction process. In other words, the opportunity to use what are commonly referred to as alpha-transport strategies becomes an integral part of portfolio design.

Breaking returns down into systematic and active components allows investors to attribute and pay fees only on the active component of returns. This is particularly important for part of the total fees. For example, investors should not have to pay performance fees on the component of return that represents a reward for having passive risk exposure to a particular factor.

Breaking away from the asset allocation paradigm and embracing the risk allocation approach offers advantages. However, it will require a change in mindset among plan sponsors, consultants and investment managers. Changing the status quo is never easy, but hopefully the current interest in alternative strategies—which only an uninformed investor would characterize as an asset class—will provide the catalyst for change.