The twin problems of measuring and allocating risk have a long history, going back to the seminal work of Markowitz. In recent years, though, users have complained that the mean-variance paradigm fails to live up to its promise when put into practice. The majority of users' complaints are centered around its extreme sensitivity to its inputs, particularly when used with a long only constraint, and its failure to account for tail risk, while the majority of proposed solutions address one or more of its deficiencies with some sacrifice of its simplicity and elegance. In spite of the complaints directed at it, the mean-variance paradigm captures the essential aspects of an investor’s problem in a parsimonious way, particularly when optimizing liquid, risk controlled, portfolios without derivatives. A simple enhancement to the mean-variance paradigm preserves its simplicity and its intuitive appeal, while accounting for risk in a more sophisticated way. In particular, I will derive a closed form risk budgeting solution that accounts for tail risk. Our method charts a pragmatic middle ground between the mathematical elegance of mean-variance optimization and the technical difficulties of tail risk optimization, and has been used successfully at a fixed income asset management firm for five years.

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