RISK BUDGETING / ALL-WEATHER SYSTEMS

Risk Parity: *Risk*, Not Labels

> Weather metaphors sell tickets; collateral haircuts and correlation spikes clear accounts. Name leverage, liquidity, and de-risking authority before marketing slides become policy.

SYSTEM ARCHETYPE 045

Risk Parity / *Budgets* /

Risk parity allocates capital so risk contributions—not nominal dollars—drive sleeves, often using leverage on lower-vol assets to balance equity risk. Anchor it in MPT inputs, sensitivity, robustness, and stock vs. flow so financing stacks respect household cash reality.

> *"Parity is about risk buckets, not equal dollars in every silo."*

1. Risk Budgets *not Labels*

Inflation sleeves and commodity tilts are policy choices with carry costs—budget them like any other premium. The adult version of balance is to document assumptions about months where equity and bonds fall together despite parity labels. When doubt appears, cut leverage before narratives. Budget entropy for roll costs, financing spreads, and implementation slippage.

Vol targeting and risk parity rhyme but differ in feedback loops—know which machine you bought. If parity relies on futures, interrogate personal liquidity lines, callable bank covenants, and spouse tolerance for drawdown optics. Correlations lie politely until they scream. Sketch causal loop diagrams for vol targeting feedback into leverage.

Tail correlations break parity assumptions precisely when parity was supposed to shine—plan for the irony. Stress the sleeve by assuming whether to de-risk automatically, manually, or hybrid—and who has authority at 3 a.m. Boring collateral management beats brilliant parity on thin ice. Budget entropy for roll costs, financing spreads, and implementation slippage.

Weather metaphors help intuition until they replace measurement: name vol, duration, and convexity explicitly. Second-order thinkers ask how financing interacts with margin haircuts, exchange holidays, and liquidity gaps in the underlying. Implementation tax is real alpha lost to friction. Stress stock vs. flow when margin calls collide with household cash needs.

All-weather marketing promises harmony across regimes; implementation is financing, roll risk, and the humility that correlations are unstable. When vol spikes, the policy should specify target vol, max leverage, and kill criteria—not only target weights. If two risk managers cannot explain the leverage stack, stop scaling. Draw boundaries between bank leverage, repo, and fund-level embedded borrowing.

Household cash needs constrain parity more than institutions admit; margin calls do not negotiate with tuition due dates. Quarterly reviews should reconcile tax drag in taxable accounts versus deferred wrappers hosting overlays. Weather is a metaphor, not a covariance matrix. Pair system sensitivity when leverage magnifies small vol forecasting errors.

2. Leverage *and Financing*

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3. Vol *Targeting*

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4. Inflation *Sleeves*

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5. Implementation *Tax*

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6. Tail *Correlations*

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7. Household *Constraints*

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RISK PARITY OPERATING CHARTER

01

Target risk and leverage caps

Numbers, not vibes—annual review.

02

Financing map

Futures, swaps, margin—who posts collateral where.

Ø3

Kill criteria

Vol spike, drawdown, or marriage veto triggers.

Ø4

Tax and location

Which account hosts overlays and why.

8. Atlas *Integration*

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Build the *lattice*, not the legend.

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