Units of Risk Explained

INSIGHT'S THREE-STEP APPROACH TO TACKLING RISK RIGOROUSLY

When it comes to investing in financial markets, investors need to be prudent when taking risks. The relationship between risk and reward is not linear, so not all risks are rewarded. In the words of General George Patton, "Take calculated risks. That is quite different from being rash."

While it may be impossible to eradicate risk, at Insight Investment we believe having a clear framework to define and describe it offers our investors a robust approach to taking it when the time is right.

Insight's heritage is servicing institutional clients in the liability-driven investing business. This means we have a tradition of catering to clients' specific needs with portfolios tailored to their requirements, liabilities and risk budgets.

"Units of risk" is our proprietary risk calibration process that endeavors to allow asset allocation decisions to be inextricably linked to a portfolio's performance targets. For over 15 years, that's what has helped Insight Investment — a BNY Mellon Investment Management company — achieve strategic outcomes for our clients.

Here, we explain that approach.

Step 1: How is the risk budget determined for Insight funds?

The risk budget of each fund is linked to its performance target and the risk-adjusted return it is expected to generate.

Once the risk budget for a fund is determined, we divide it into eight equal slices, or "units." These are the units of risk, which a portfolio manager can use to allocate to different assets within the fixed income universe.

We choose eight units primarily because doing so maintains the statistical significance of each denomination and secondly because it presents, in our view, a practical framework to work within.

Step 2: How does the portfolio manager "spend"the risk budget?

After combining top-down and bottom-up investment views, portfolio managers can allocate (or "spend") their units of risk accordingly. For example, if they believe investment grade credit spreads are attractive, they may wish to spend one unit "long." Similarly, if they believe high yield is unattractive, they may opt to allocate one unit "short." It is important to state that these are not physical short or long positions, simply our way of expressing whether a manager is favorable towards an asset class or not.

In practice, it is not quite as simple as allocating 1/8th of a portfolio's active positions to investment grade or high yield. High yield is historically more volatile than investment grade, which means a lower allocation to high yield would likely be required to generate the same level of active risk as an investment-grade allocation.

Insight's teams have analyzed the long-term historical volatility of each fixed income asset class and we continue to monitor and review these measurements on a regular basis.

We use these to calibrate allocations to different asset classes accordingly, to help ensure one unit of risk can genuinely seek to correspond to 1/8th of the overall risk budget. This is also helpful because it creates a common language for our investment professionals to use when discussing different sectors that have historically behaved differently from one another, increasing our decision-making efficiency.

When allocating risk, Insight portfolio managers selects how many units long or short they wish to be exposed to across each available source of return, subject to hard limits between +3 and -3 in any single asset class or strategy.

The result may look something like Figure 1, where the manager is 1.5 units long asset-backed securities ("ABS"), half a unit short high yield and neutral duration. While the limit on absolute units per strategy is three, in practice, single allocations above two units are rare unless valuations are particularly stretched.

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Step 3: How does Insight take extra precaution towards correlation?

Fixed income markets, such as investment grade, high yield, loans, ABS and others, are likely to be subject to correlation. As a result, allocating units of risk in a similar manner across several asset classes may leave an investor exposed to correlation risk, unwittingly causing the portfolio to exceed its risk budget.

This is why the final step of the units of risk approach is to factor correlations into the analysis. We use our risk system to perform scenario analysis to generate the portfolio's expected tracking error (the degree to which a portfolio differs from its benchmark).

If these estimates of total risk are outside acceptable limits, the portfolio managers will scale back their proposed units of risk allocations until the required conditions are satisfied. The same analysis will also indicate any potential diversification benefits.

Figure 1: An example of units of risk positioning

Unit of Risk	-3						0					3
	←Min→						←Max→					
Govt Intermarket							+0.5					
Index-Linked								+1.0				
Swap Spreads							0.0					
Duration							0.0					
Yield Curve								+1.0				
Investment Grade Corporates								+1.0				
High Yield						-0.5						
Loans							+0.5					
Investment Grade ABS									+1.5			
Emerging Markets Debt								+1.0				
Currency							+0.5					

For illustrative purposes only and not indicative of the portfolio of any specific product..

Conclusion: Why you should care about our units of risk process

Rather than part of the investment decision, our units of risk process is an essential tool providing Insight portfolio managers, analysts and risk teams with a common language and a unified approach. The result is an entirely bespoke method, with institutional pedigree, that is applied to our full suite of fixed income portfolios and for each and every client.

Please note, the specific investment limits and restrictions as they relate to the BNY Mellon Insight Core Plus fund are outlined in the fund's Prospectus and Statement of Additional Information.

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RISKS

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