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Increased Leverage = Less Risk?

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All else equal, the use of leverage increases investment risk. But, can it ever have the opposite effect? Investors using the so-called risk parity trade believe the answer is yes. Under this approach, a portfolio is built using equity and debt, but the debt is purchased using leverage. The strategy is based on two key points: (1) equity is more volatile than debt and (2) debt returns are negatively correlated to equity returns. Thus, with leverage, the debt returns are in effect more volatile. When combined, the negative correlation creates a less risky portfolio as the equity and debt returns balance each other out. See article here, Wall Street Journal.

Related Chapters: Chapter 11, Chapter 12