Institutional investment

March 2019, 5 min read

Implementing risk-reducing strategies

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As many investors have benefited from rising equity markets over the last few years, they have often looked to protect those gains and to protect against further volatility. The recent equity market turmoil (i.e. the significant declines in Q4 2018 and recovery in January), has highlighted the importance of risk management, and more specifically, of risk-reduction programmes as part of investors' overall investment strategy.

Equity exposure is often the largest risk in institutional investors' portfolios. Over the last 18 months, we have seen investors adopt a variety of strategies, including the very popular option-based approaches, taking advantage of lower implied volatility and high equity index values. Doing so has allowed investors to keep to their longer term strategic objectives and maintain their long equity exposure, while protecting their portfolio from the more immediate threats posed by the market. In many cases, the term of the protection purchased was matched with a strategic milestone. For example, one might take steps to protect a pension fund against declining equity markets up until the next actuarial valuation date.

> Although option-based strategies have been popular of late, there are a variety of approaches that investors can use to achieve the goal of reducing equity risk.

In this article, we will discuss the main risk-reduction strategies for minimising exposure to equity markets.

Investment Considerations

Investors should weigh the importance of different criteria in formulating their risk-reducing plans, in the first instance. Here are some to consider:-

- Type of Risk: is the investor more concerned about an overall reduction in portfolio level volatility, about sharp losses and tail risk, or about extended drawdowns? Is there some protection required for a specific event risk (eg Brexit)? Is correlation risk an important part of the objective (for instance, protection against the failure of equity/bond diversification)?
- Degree of protection required and cost of carry: is more explicit/hedging risk required, or implicit (diversification)? The more explicit the risk transfer, the more expensive it tends to be. Is there an explicit budget for protection that is to be defined?
- Capital efficiency requirements: is an implementation via a derivatives overlay a requirement or possibility?
- Fiduciary responsibility: Is there an internal appetite for market-timing and rebalancing or should this be delegated?
- Implementation risk: what is the impact on counterparty risk, resulting from the implementation of new instruments?

The Strategy Universe

While each investor will have its own risk profile, the various approaches below all necessitate the flexibility to short, or use derivatives, either directly trading or indirectly, through allocating to funds.

There are three broad risk-reduction categories: explicit protection, contingent strategies, and diversifying strategies. There is generally an inverse relationship between the predictability of the protection characteristics and the cost of carry. This is described in turn for each strategy below.

- Explicit protection strategies comprise a direct allocation to short-biased equity strategies, which seek to generate returns through security selection, whilst maintaining an overall net short position. Whilst this is a predictable way to reduce overall exposure, it involves a reduction in the aggregate equity premium. Another way to achieve explicit protection is to implement a constant hedging programme via options or other volatility products, but this can be expensive (depending to a large extent on implied volatility levels).
- Contingent protection strategies are more affordable, and there are several types that use options. One approach is to use a derivative overlay strategy and construct a payoff profile specific to the requirements. Certain actively managed option strategies seek to reduce the cost of carry by seeking to time the markets, or by following a relative value hedging strategy. For instance, a manager may seek to maintain a long volatility profile.
- Diversifying strategies offer a more indirect route by using certain actively managed strategies, with the trade-off being the benefit of positive carry. Strategies such as trend-following display a positive skew by virtue of seeking to capture extended market moves. However, this is only statistical and, in the past few years, these strategies have generally failed to perform as expected. A discretionary global macro approach, whilst not an explicit hedge, is suited to navigating certain risks; this is due to the optionality in trade construction which is a frequent feature of this approach, and due to the wide range of instruments available.

In aggregate, the above strategies tend to have a positive convexity profile as a by-product of their investment approach and this helps contribute to overall portfolio protection.

Search and Implementation

A successful search and implementation programme should take into account several aspects which vary for each investor. After a holistic review of the investment considerations, above, it is useful to determine the acceptable trade-offs from the point of view of the overall distribution. The different properties described above translate to quantitative aspects of mean reduction (i.e. reduced expected returns), upside limitation, or downside protection.

Following a shortlist of providers, it is important to quantitatively assess the overall portfolio together with the proposed risk-reduction allocation. While it is usual to consider the benefits of new investments with reference to their diversification properties, in the case of risk-reduction strategies these complementarity properties are core to the objective of the exercise.

Conclusion

> The implementation of a risk-reduction programme is a customised exercise which is dependent on each investor’s individual requirements and risk tolerance.

In many cases, these considerations lead to the design of a risk-reduction strategy that is specifically tailored to complement the original portfolio.

We believe that a tactical approach to reducing risk, in the way described above, is not only very topical, as markets have rallied again since the recent declines presenting another opportunity to execute a strategy at a favourable price, but it is also an important tool in an investor’s arsenal, allowing strategic asset allocation to remain largely intact, while addressing the ever-changing risks present in the market.

Tags: investment , investment advisory , risk