Investment Insight

Alternative ways to hedge your share market risk

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Gareth Abley
Head of Alternative Strategies

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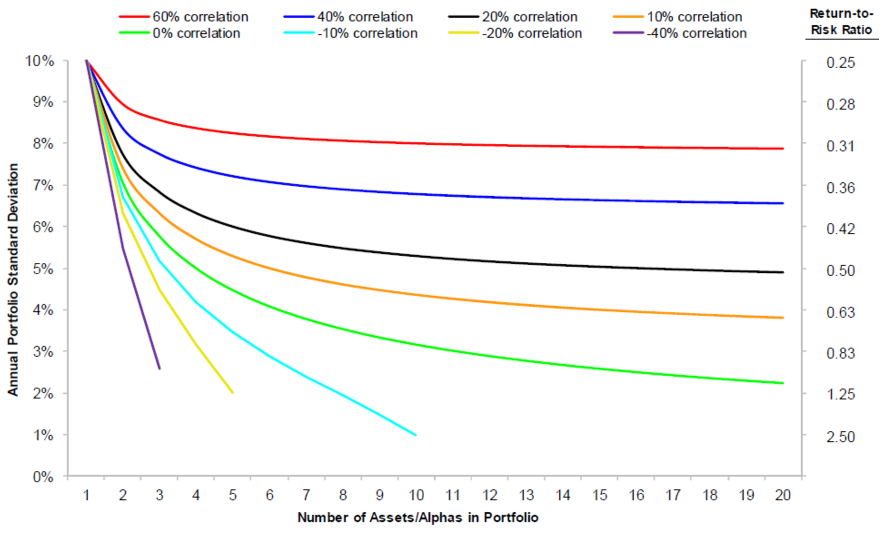
As we head into our seventh year of a share bull market with bond yields globally at record lows, many investors are left scratching their heads. Share market returns have tended to run ahead of actual company earnings and the traditional low risk, diversifying asset class (bonds) is arguably higher risk and less diversifying than it has ever been. This is a big challenge for any investor intent on generating attractive returns while mitigating the risk of capital loss.

One response is to identify 'alternative' strategies that can generate positive returns and be uncorrelated to share markets. Even more enticing, is a sub-group of strategies within this universe that claim to be able to generate positive returns when share markets sell off (ie be negatively correlated to falling share markets). It is this sub-group of alternative strategies that is the focus of this article.

Correlation matters a lot

It's worth starting by reflecting on the importance of the correlation of assets. Our first instinct as investors is often to focus on the expected return and downside risk. However, the magic of diversification means that combining strategies with a low (or negative) correlation can make a huge difference to your portfolio's returns. Chart 1 shows how adding strategies with a negative or low correlation can disproportionately decrease your overall risk (standard deviation).

Chart 1: Correlation between asset number and standard deviation



Source: Bridgewater.

The incremental reward, in higher returns, for taking on risk is the key – the higher this is, the better for an investor – and the lower the correlation of a strategy that is added, the more pronounced the portfolio enhancement.

This potency has been at the centre of our thinking with regard to investing in alternative assets in the Low Correlation Strategy. MLC Inflation Plus and MLC Horizon portfolios invest in the Low Correlation Strategy where our focus is on strategies with a positive expected return and a low correlation to both share markets and each other.

There is an interesting sub-set of strategies in the world of alternatives that aim to generate a positive return when share markets are negative. In a world where most portfolios are dominated by share market risk, this is a hugely alluring characteristic. The question is, can it be reliably achieved and at what cost?

The short answer is that there are a range of strategies in this space, with varying levels of reliability and payoff profiles. Before we touch on these, it is worth making a couple of high level observations on markets and volatility which are integral to understanding some of the trade-offs.

Key facets of volatility

The use of options is a common way to hedge share market risk. Hence they are commonly used in these types of alternative strategies.

So, why not use options as a hedge against share market risk? The answer is because put options on share markets are structurally expensive. This is precisely because so many investors are exposed to share market risk and want to hedge it.

So while buying put[1] options can potentially provide a payoff when share markets fall, the odds are that they will detract value over the long-term (unless an investor has the skill/luck to only buy them just prior to a crash – which is something we are pretty sceptical of).

The continuum of strategies to hedge share market risk

There are a number of ways in which investors can hedge their share market risk.

The first is to simply buy put options against the share market exposure you are most concerned about. There are many nuances in how you can do this (eg which strikes, tenors, puts vs put spreads etc), but this is a direct and simple approach as long as you have the capability to implement it yourself. It allows you to ‘sculpt’ your possible returns according to your own specific objectives and without incurring fees to fund managers. MLC has a Specialist Derivatives Overlay team that helps us selectively use options to improve the risk return profile of our strategies, including MLC Inflation Plus.

For those without in-house expertise, there are a number of specialist fund managers that actively use options. We have researched a number of strategies in this space along a continuum of risk-return profiles. At one end of the spectrum are managers who predominantly buy stock put options – with the ‘goal’ of losing money most of the time and having a very high likelihood of making asymmetric returns when share markets fall. At the other end of the spectrum, are managers who aim to generate a positive return each year (through skill or harvesting certain risk premium) and also make money when share markets fall (often through the purchase of options). Clearly, this return profile is highly alluring, but less reliable.

Volatility related strategies, which aim to make money when share markets are down, have a number of nuances (both technical and behavioural) that require careful consideration – so it is important to think through the trade offs carefully.

In an industry that thrives on creating complexity, it is also worth reflecting on the fact that there is one very simple and cheap way to reduce share market risk; cut your share market exposure!

Conclusions

There are a lot of strategies touted as offering protection against declines in share markets and many of them at first glance appear very alluring, particularly given the current challenges facing investors. However, as always, it is worth being sceptical and having a disciplined framework for evaluating these strategies.

[1] **Put option** gives the owner the right to sell a stock at a pre-defined price within a period of time; **Call option** gives the owner of the option the right to buy a stock at a pre-defined price within a period of time even if its price rises above this maximum.

Firstly, perhaps the most important takeaway is that there is generally a cost to accessing negative correlation. This 'cost' could include:

a) An expected negative 'through the cycle' return akin to the cost of paying for insurance
b) Uncertainty regarding the nature and reliability of the payoff in a negative share market (either via basis risk[2] or due to a reliance on uncertain skill/timing/factor characteristics).

Secondly, we know in advance that there will be some strategies that do deliver very positive returns during the next big share market drawdown. These are very easy to identify after the event! (This induces hindsight bias - the belief that we would have picked them beforehand). As we know, they are much harder to pick before the event – particularly given each crash tends to be different.

Thirdly, while we believe investment success is a game won at the margin by doing lots of things as well as possible, it is hard to allocate enough to this type of strategy for it to make a material difference to the overall portfolio (without materially compromising expected long-term returns).

Overall, our ethos is to retain an open (and sceptical) mind on these types of strategies. On balance, we think it makes more sense to focus on strategies that have both a positive expected return and that are uncorrelated (rather than negatively correlated) to share markets – which is our main focus within the Low Correlation Strategy. This type of exposure can be more reliably generated and can generate consistent positive returns. It can also still deliver a hugely beneficial return profile for investors, particularly in the current environment.

[2] This refers to the risk of two related assets not performing as might be expected. For example, a manager may look to hedge share market risk by buying options on the Korean Won (which they might view as artificially cheap due to structured product dynamics in Asia) rather than on stocks (where puts tend to be structurally expensive). This is premised on the view that when share market volatility increases, it is likely that the volatility of emerging market currencies will also increase. The 'basis risk', is the risk that they don't ie it is an imperfect hedge.