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Managing Equity Risk in 2018

Protecting gains yet remaining invested

The bull market in US equities continues and approaches its 9 year anniversary – the second longest since WWII. In 2018, many investors face an uncomfortable dilemma. Past gains can be locked in from a position of relative strength but strong economic conditions and the desire to outperform bonds mean many will also wish to stay invested. We look at how to protect against market declines while retaining equity upside exposure.

The past year in review

Equity returns have exceeded the expectations of most investors. At the end of 2017, the S&P500 had posted a gain in 14 consecutive months signalling not only strong performance, but also a decline in market volatility and an increased resilience to events that previously might have triggered a sell-off. Despite the Fed increasing interest rates, political uncertainty in both the US and Europe, and the threat of war in Korea, any dips in equity markets have been temporary and treated as a buying opportunity by investors.

We highlighted at the beginning of 2017 the increased upside and downside in equity markets following the election of Donald Trump ("Equity Risk Under Trump-onomics"). The upside factors have dominated. We have seen tax reform finalized and potentially economically damaging policies relating to protectionism yet to materialize. However, probably the more significant wind in the sails of markets over the past year has been strong economic growth in all major global regions for the first time since 2007.

Looking forward to 2018

Equity valuations look historically expensive and we are seeing increasing evidence that we are relatively late in the economic cycle. However, we have yet to see the indicators of an economic slow-down that could provide a clearer message to sell equities and take the gains achieved to date. In fact, on a *relative* basis, we currently prefer to take risk in equities rather than government or corporate bonds while at the same time we acknowledge the very real risk of a market fall.

What does this mean for investors?

The continued rise in equity markets has placed many funds in a significantly stronger position than a year ago. When considering what to do now with their equity allocation, investors have essentially four choices:

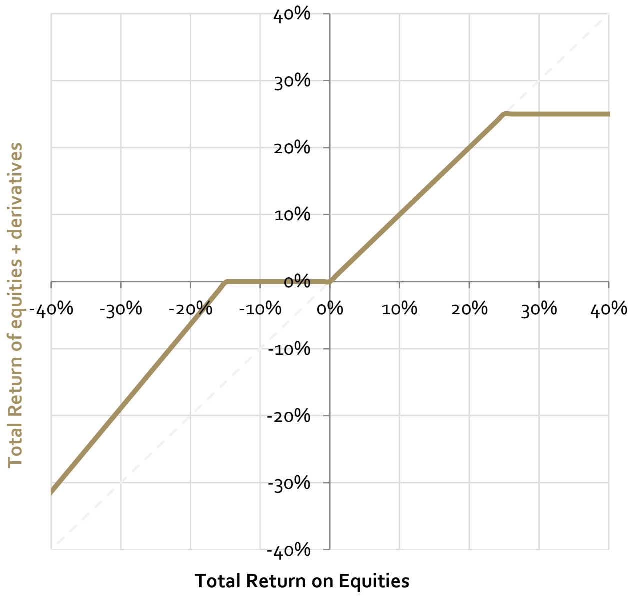
	Objective	Challenge
Retain Equities	Stay invested to achieve long-term Equity Risk Premium	Living with volatility
Sell equities to buy bonds/cash	Less exposure to equity-like assets	Low yields Risk of rising interest rates (bonds)
Diversify with alternatives	Reduced volatility through exposure to hedge funds, or other diversifying asset classes	Reliance on past correlations Higher fees Increased governance
Protect with derivatives	Retain equity returns, but protect downside in a predefined way	Reliant on option market pricing Decisions required on level of protection/upside retained

Many investors will use recent gains as a trigger to sell equities and buy bonds or cash to lock in some of that improvement. However, many investors will still want or need to retain significant return seeking asset exposure, in some form.

What can be achieved using equity options?

The chart below shows the total return over 3 years of an example strategy using equity options combined with passive equities. The return of the strategy, shown on the vertical axis, is a pre-defined function of the total return on the equity market (shown on horizontal axis). The equity market is the S&P500, although a similar shape is possible for other major indices such as the MSCI World:

Total returns using derivatives over 3 years:



As at 8 January, 2018. Net of estimated transaction costs and fees.

The equity options used require zero up-front premium and are held in addition to existing equities. This gives rise to the following characteristics:

- **Capital protection** if the total return on equities is as low as -15% over the next 3 years; downside participation is resumed thereafter (achieved with put options)
- **Some equity upside is forgone** because the total return of the strategy is capped at 25%, achieved by selling a call option.

Comparison of total returns over 3 years:

Passive Equity Return:	Strategy Return:	Performance Comments
-30%	-19%	Guaranteed **outperformance** if total equity returns are less than zero.
-15%	0%	
0%	0%	**Match** passive equity performance if total equity returns are between zero and 25%.
25%	25%	
40%	25%	Guaranteed **underperformance** passive equities if equity returns are more than 25%.

In summary, equity derivatives can be regarded as an additional tool in the toolbox to manage equity risk beyond simply continuing to hold equities, buying bonds or diversifying away from equities. Potentially vunerable equity markets can be protected in a pre-defined way that is both transparent and low cost.

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