Summary

- Interest in defensive strategies are rising as investors want to lock in the gains they have made.
- Predicting the future of equities markets is difficult and defensive strategies that offer upside potential and downside protection are looking attractive.
- There are a variety of strategies, ranging from low volatility to option-based overlays and mixing convertibles and equities.
- Each comes with their own set of challenges and investors have to be aware of the risks.

On the defensive

With institutional investors turning their attention to equity defensive strategies, Lynn Strongin Dodds reports on the variety of options available and the challenges and risks they pose

Although equity markets continue to defy gravity, the end of last year is a reminder that valuations can unexpectedly plunge. Not wanting to get caught by surprise again, institutional investors are revisiting equity defensive strategies. While low volatility remains a firm favourite, options strategies are increasingly becoming part of the mix.

According to Mercer's *2018 European Asset Allocation* survey, allocations to defensive equity strategies are up by 12 per cent. One reason is that timing the end of the prolonged bull market has been tricky. For example, the strong rally since the beginning of this year indicates a positive outlook for equities but on the other, falling bond yields suggest that that there is trouble on the horizon and investors are running for cover.

PanAgora Asset Management director, multi-asset, Nick Alonso, believes that "there is a growing consensus that we are in the later stages of the economic growth cycle and positioning an equity portfolio for an uncertain path forward is prudent."

"Equity markets have been in a bull market for a very long time but there are economic signs that growth is slowing," he adds. "For example, Eurozone Q4 gross domestic product slowed to just 0.2 per cent and there remains uncertainty as to the resolution and timing of Brexit".

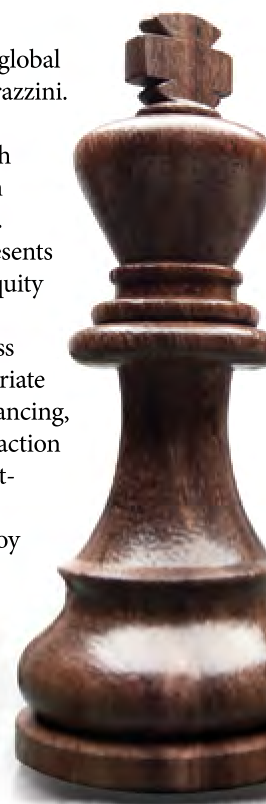
However, State Street Global Advisors managing director, EMEA head of investment strategy and research Altaf Kassam thinks "we are in a 'new normal' and nowhere near the levels we would be at if we were at the end of a normal business cycle".

"This can go on a lot longer if the patient stays on the QE drip and central banks continue to be accommodative. However, as we have seen before, something can always come out of left field, and people want to protect the gains they have made over the past 10 years."

Kassam also notes that UK defined benefit schemes do not need the same high levels of returns that they did in the past. They have benefited from strong equity returns and closed their funding gaps. As a result, they can adopt a defensive approach and relinquish some of the upside for downside protection.

Spoilt for choice

As with many investment approaches, equity defensive strategies come in different flavours with varying degrees of protection, complexity and returns. One of the most popular is and has been the low or minimum volatility funds, whereby investors gain exposure from smart beta products or funds. Empirical evidence points to the low volatility anomaly, which shows that these securities, because they typically fall less in down markets, tend to generate higher risk-adjusted returns over the longer term. They proved their mettle in 2018 where Brexit, slowing global growth and continuing trade tensions between China and the US took its toll in the fourth quarter. Research from MSCI showed that its Minimum Volatility Indexes across different regions outperformed their corresponding broad market indexes by six percentage points and higher.



Variable beta and quality stocks are also in vogue. "Within defensive equity, strategies focusing on quality equities are well-proven in the long term. These strategies invest in stocks where the underlying companies have high quality earnings, with characteristics like stability of dividends, high return on equity, and low accrual ratios," says Mercer investment consultant Matt Scott. "We are also including variable beta strategies under the heading of defensive equity, where managers have the flexibility to move from equities to fixed income, cash or even gold, if they feel equity valuations are unattractive. They would also typically invest in lower beta sectors, canonical examples of which include the healthcare or utilities sectors."

Looking at all options

Sitting at the more complicated end of the spectrum are the market neutral long/short equity strategies, as well as option overlays, which are gaining traction. They involve buying puts and selling calls to reduce the volatility and drawdown potential of equities. "Here either the asset manager acts as an adviser for in-house teams or is allocated an amount of cash or portion of the equity portfolio to use as collateral for the hedge," says LFIS head of fund solutions Edouard Laurent Bellue.

He adds that another alternative to hedging is funds with a differentiated defensive profile. "We have seen growing interest from institutions in this sort of solution, which employs a multi-asset approach using derivatives not as an overlay but as a means to take more defensive equity positions," he says.

Parametric Portfolio Associates, the quantitative affiliate of Eaton Vance, has a slightly different option twist with its global defensive equity fund which is split between cash and equities. It seeks to harvest the volatility risk premium and does so by selling short dated out of money call options on the equity securities, and put options on the cash position. The aim is to deliver outperformance in negative, flat and modestly high equity markets and trail, albeit with positive returns, in strong markets.

"The use of options can meaningfully add to portfolio performance," says Parametric Portfolio Associates fund manager Alex Zweber. "The objective is to deliver equity-like returns but with a much smoother ride than many other traditional equity strategies. The other benefit is that this is a cheaper alternative than an equity hedge fund strategy."

Another variation is funds that combine equities and convertible bonds. "Investors are concerned about a variety of downside risks today and the level of risk asset prices broadly, but timing the markets is difficult," says Calamos Investments senior vice president, co-portfolio manager Dennis Cogan. "Investors are also uncomfortable being on the side lines when there is a strong market rally. We think our lower-volatility strategies are a good solution because they keep investors exposed to the equity market but provide a better risk-return profile."

Cogan says that the Calamos Global Opportunity Fund blends convertible bonds and equities across sectors and geographies. The structure of convertible bonds that have principle protection similar to straight bonds along with the option to convert into common equity provides a natural asymmetry that has the potential to deliver long-term equity-like performance with lower volatility. By combining convertible with equities, we can calibrate equity market exposure and maintain the favourable upside and downside capture dynamic through the cycle."

There is of course no free lunch and each approach comes with its own set of issues. For an actively-run equity run strategy these may include forecasting risk for each company, avoiding unintended bets and excessive concentration, according to AQR principal and co-head of global stock selection Andrea Frazzini. "Some defensive equity portfolios can end up with large concentrated bets in a few industries," he adds. "Implementation also presents a challenge. As with all equity strategies that take active bets, paramount to success is determining an appropriate level of trading and rebalancing, taking into account transaction costs and trading in a cost-effective way."

If the portfolios employ option overlays then a larger governance budget and oversight function is required. "There is an operational intensity because pension funds may need to make decisions quickly in terms of whether they want to vary the hedging or roll over the contracts," says Scott. "There is also a documentation burden. However, this is often easier if the UK pension fund has a segregated liability driven investment strategy and manager because much of the documentation and a pool of collateral will already be in place."

Wellington Management multi-asset strategist Ben Cooper also notes that the cost of portfolio hedging with options varies substantially – 50-250bps p.a. – and for many clients, especially those with long investment horizons, this is prohibitive," he says. "In such cases, we have seen more interest in risk-mitigating strategies, such as macro or relative hedge funds, or alternative risk premia strategies. Attention should also be paid to the details of the structure – maturity, strike prices, and the underlying asset, as well as the operational and reporting set up."

Written by Lynn Strongin Dodds, a freelance journalist