Innovative Investment Strategies in Volatile Times

We find ourselves in difficult times. The global effects of COVID-19 have wreaked havoc on investment markets, on daily life, and on institutional investment pools such as pension funds and endowments. Treasury yields have plummeted, credit spreads have widened, and major equity indices have fallen to levels not seen since 2016.

In times like these, many investors are wondering how they can possibly find their way out – minimize further losses while being positioned to take advantage of upside when it appears. There are still many unknowns and it is impossible to say when markets will stabilize. So what can institutional asset owners do now to not only weather the storm, but to also thrive in the face of unparalleled difficulty? Unprecedented times like these call for innovative strategies.

Why Is Innovation Needed?

Typical investment strategies like liability driven investing for corporate pension plans or total return strategies have shortcomings. These shortcomings cause strain as investments decline and they need the markets to rebound strongly to get back on solid footing.

Options To Improve Risk Profile and Return

For in the current environment, asset owners are looking to control risk while accessing upside potential when the market eventually stabilizes. Traditional strategies have to be set aside or supplemented with other strategies that can achieve this outcome.

Investors need additional tools in their portfolios today. These tools will need to involve equity and fixed income option contracts to shape their return to have a high likelihood of achieving the objects with risk and return. Using options can have several advantages including:

- Allowing for protection against further downward slides
- Providing for upside potential
- The ability to benefit directly from markets stabilizing

Option contracts (i.e. puts and calls) allow investors to buy or sell risk and potential return, allowing investors to create exactly the risk and return profile they desire with potential outcomes defined in advance and secured by contract.

Some option combinations are quite attractive today given increased market volatility. The next section shows some examples of how these structures work in practice, but ultimately what is the “right” structure for a particular investor will depend on their goals, objectives, and risk tolerances.

Examples

The easiest way to picture how these strategies work is to start with a simple chart that shows a 1:1 relationship between equity market returns and equity returns in an investment portfolio. If equity markets increase by 10%, the equity portfolio increases by 10% as seen by the dotted line in the figure below.

Options can change that 1:1 relationship based on what an investor is trying to achieve. A basic shape an investor can use is to buy downside protection, with the cost of this protection partially or fully financed by selling off some of their upside potential. This strategy is known as a “collar”.

The figure below shows the impact of having a type of collar on an equity portfolio. For example, if equity market returns are between -30% and +30% from today’s level at the end of three years, the value of this collar plus an underlying equity portfolio will deliver returns of between 0% and +30% (ignoring any impact from active management of the underlying equity portfolio or fees).

Anything below -30%, the collared portfolio will participate in the losses, but will still be well ahead of straight equity returns. Returns over +30% will be paid away to the counterparty that took the other side of this collar. The result is that the investor will have a pre-defined range of return outcomes.
These strategies are fully customizable which allows an investor to be creative. For example, an investor can add more exposure to smaller equity market upside movements, taking advantage if markets rebound, to a point.

Both of these collar strategies might be used by investors as an alternative to just adding additional equity as part of a re-risking process. Having the ability to shape outcomes can enable committees, many of whose members may still be quite nervous about markets, to make better decisions.

Using options, asset owners can also express a stronger view on a future reduction in volatility, but with less of a view on markets in general. An interesting shape to capture upside from a reduction in today's highly volatile environment can look that like the figure below. This return profile returns a fixed, positive amount if equity market returns are anywhere around current levels (high or low). The shape doesn't return anything if there are large rises or falls in the market over the agreed upon time horizon.

Case Study

A case study will help to illustrate how option strategies can work in practice. This example looks at a company that was eventually looking to fully terminate their pension plan. To get to that point they started using an options strategy back in 2005. Based on the market environment, they would change the shape of their structure to reflect their views (i.e. adding protection on the downside or levering up the upside potential).

With this strategy they were well positioned going into the Great Financial Crisis in 2008 having protection from the steep equity declines that played out in the market. However, what's more interesting and relevant to today is that they were also positioned to take advantage of the market recovery in the subsequent years which accelerated the growth of their equity portfolio as markets improved.

The end result: the company was able to reach their goal of termination in early 2018. took the other side of this collar. The result is that the investor will have a pre-defined range of return outcomes.

Why Implement Now?

Traditional investment strategies may have substantial shortcomings in the current market environment. Asset owners may need to do something different if they want to weather this turmoil and come out on the other side in good shape.

The above illustrations of option strategies are ones that may be appealing today. As we are working in fast moving markets, the situation may look quite different tomorrow. To implement these strategies, there is set-up time and paperwork that needs to be in place. Once it's in place though, investors can act quickly to put on a structure when the time and price are right – which is important today as opportunities can be fleeting. Once implemented thoughtfully and correctly, these tools can provide substantial upside to investors that have found themselves with substantially deteriorated asset levels or funded status in 2020.

To see how this investment strategy can work for your situation please feel free to contact the authors seen on the next page.
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