Protecting portfolios from downside risks

Russell Investments

Many institutions remain significantly exposed to downside risk. Managing this risk can be complex and costly. What, if anything, can investors do to protect the value of their portfolios?

Downside risk can be managed in various ways. At Russell Investments, we work with large global institutional clients to provide various protection strategies. Tactical downside protection works well for clients with shorter-term and tail-risk market concerns. Those with a longer-term strategy for whom on-going asset level protection is key, a strategic overlay may be an ideal solution.
In this article, Russell Investments explores various derivative based protection strategies for investors wherein more conventional measures (e.g. reducing equity exposure, seeking low-volatility equity exposures, increasing the diversity of the portfolio structure) may prove inadequate.

Downside protection overlays can be designed in various ways. Here we present two types of downside strategies which we categorise as (1) tactical or (2) strategic.

A tactical hedge is one that has a short time horizon, but provides fairly solid protection. These are usually implemented with index or equity options.

A strategic hedging programme is one that can be maintained on an ongoing basis. Strategic hedges can accomplish several goals – including reducing volatility, offsetting drawdowns and embedding asymmetry in the potential return distribution (where value can go up more than it can go down).

Tactical hedges

For specific portfolio insurance or protection in certain market environments and projections, one avenue to protect portfolios from downside and tail-risk are options-based strategies. These would involve the purchase of a put (or a cheaper put spread) at a desired strike level.

The rationale for tactical protection strategies is optionality to benefit from a potential equity market pullback. The options market offers investors the ability to target a wide range of portfolio outcomes. Different option strategies are designed to meet different goals, have different potential payoffs, carry different risks and costs, and are attractive at different points in time based on many market factors. Some option strategies are intended to change the returns of long-term asset classes, while others are more tactical, based on shorter-term views of market levels or the attractiveness of option strategies.

Option strategies, though providing protection at a cost, are better suited for shorter term market outlooks where current capital markets views suggest an expected market level for which one is willing to sacrifice upside.

Pure tail-risk hedges using puts are meant to function on a stand-alone basis, similarly to a traditional investment mandate. Capital allocated to the account sets the maximum possible loss over the time horizon of concern. Such solutions have a performance pattern that gradually declines over most periods, but benefits from a large gain when significant market corrections occur.

Though providing absolute protection below a certain market level, put strategies in isolation can be very expensive.

For example a 90% put on the EuroStoxx 50 Index for 1 year costs over 3% in premium as of the 10 January 2020 (0.9% premium can be saved if a 75% put is written, this is referred to as a put spread).[1] In limited circumstances, upside can also be sold (writing a call) to finance protection via puts, however, the attractiveness of a protection strategy is its ability to capture upside in a trending rally. When the put spread is purchased, and financed entirely by writing a call, that structure is referred to as a put spread collar.

Investing in options-based risk management strategies requires two critical elements to be successful: an infrastructure and investment platform that enables timely implementation of solutions, and a total-fund risk management program that can measure, evaluate, and manage the impact of options exposures on underlying portfolios.

Source: 1 Bloomberg, 14th January 2022

An investor entering into any option needs to gain a clear understanding of the relevant strategies, and of the investment outcomes they are designed to achieve; the investor needs also to give due consideration to the option's current pricing and attractiveness, factors that can change significantly even over short time periods.

Strategic hedges

As paying for pure tail-risk insurance with options can be prohibitively expensive on a recurring basis, an ongoing futures-based strategy can provide significant downside protection and provide a long-term equity risk management strategy. A futures based strategy allows plans to maintain higher exposures to equity markets, in a cost effective and more efficient manner than using option strategies. The strategy aims to eliminate extreme downside tail outcomes and deliver a balance between upside capture and downside protection and provides an improvement in wealth compounding by reducing the impact of negative market returns; a feature in which during times of reduced equity exposure, maintain the alpha of active management while avoiding negative returns by reducing or eliminating market beta.

A dynamic strategy provides a soft asset floor level which is effective under most circumstances - certain dramatic market declines may result in asset value falling below the intended protection floor, but accepting this residual tailrisk dramatically reduces the cost of protection.

This type of mandate is structured as complementary protection of an underlying portfolio holding. In this instance, performance of the sum of the underlying holding and the protective overlay is the appropriate focus. Such protection allows for the creation of a holistic protection with set floors and more precise drawdown limitations or target volatility levels.

The ongoing overlay provides flexibility and adjusts equity exposure, potentially intra-day, taking into account the above factors. The flexibility provided by the futures based solution allows for more protection when there is additional downside concern, or more upside participation when forecasts are positive.

Summary

In the present rocky market environment, many investors find themselves significantly exposed to extreme market falls. Others are looking to enhance traditional static allocation with more dynamic behaviour so as to protect previous gains. Russell Investments has been managing a number of downside protection strategies for large institutional investors globally for several years.

Where investors in practice struggle to manage their strategic asset allocation effectively in order to meet the demand of their liabilities, dynamic asset floor protections strategies provide a risk-controlled framework for achieving this. As such, this is an important ingredient of institutional balance sheet management for the 21st Century. In our current climate of heightened risk and low returns, investors should seek overlay professionals who have the experience and capabilities necessary to manage this critical aspect of portfolio risk.

For more information

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