

HAS «BUY AND HOLD» HAD ITS DAY? THE CASE FOR MORE DYNAMIC EQUITY EXPOSURE

Whenever bad news about insufficient liquidity ratios at pension funds and the like starts pouring in, the frenzied search for the culprits is never far behind. The high technical interest rate, negative market performance, unreliable hedge fund constructs and unfavourable member demographics are often cited as causes of the calamity. This is compounded by the fact that each pension scheme has a different point of departure. Institutions experiencing strong growth, for example, are in a much better position to make up for temporary shortfalls than those with a large contingent of beneficiaries.

However, none of this can hide the fact that for the second time in ten years the global equity market has slumped by over 40% (top to bottom) and has wrought havoc among pension funds' mixed portfolios. The underlying cause of this situation, which has assumed catastrophic proportions in some cases, is neither the bedevilled hedge funds (despite the fact that their returns of -15% to -20% p.a. have fallen well short of their promised «absolute returns»), nor highly volatile commodities, since both were only implemented to a marginal extent (<10%) in the portfolios. The real lossmaker, in most cases, is the portfolios' 30-40% equity exposure. On close scrutiny, these investments turn out to be essentially unsuitable for investors that are required to report their liquidity ratio annually. There has been virtually no public debate about

this issue to date, due in part to the fact that the asset management industry has so far put forward few convincing concepts for limiting the risk of share price drops. In view of the academic debate on «regime shifts», the time is ripe to address this matter and move away from the traditional belief that «equity lows simply have to be accepted and endured».

Wouldn't an equity strategy that cut away a significant portion of the downside risk at the expense of some of the upside opportunities be much more suitable for pension funds? In our view, there are four different ways in which such an approach can be implemented. The first two are generally well known, but nevertheless require a major revision; the other two are more novel, at least in terms of how widely they are known and how frequently they are implemented.

OPTION 1: PORTFOLIO HEDGING WITH STRUCTURED PRODUCTS – BUT WITH LOWER COUNTERPARTY RISK PLEASE!

If an investor aims to achieve returns that are as asymmetrical as possible, structured products are the obvious choice. Tailored and flexible risk/return profiles are among the core features of this form of investment. However, owing to the counterparty

risk, it is impossible to invest a large portion of the equity investments in capital-protection products («principal protected notes»). Pension funds are therefore advised to purchase the components contained in structured products separately. This may sound complicated, but in practice it is not. The bulk of the capital is used to buy top-tier bonds (e.g. zero-coupon bonds) and the remainder to buy long-dated call options. The counterparty risk is limited to the 10–20% share of the portfolio allocated to options. A counterparty default would only cause damage in a bull market, since, in a bear market, the options would expire worthless. A default by a counterparty in a boom phase is much less likely than during a crisis.

OPTION 2: ACTIVE MANAGEMENT OF EQUITY LONG/SHORT STRATEGIES – LIQUIDITY AND TRANSPARENCY AS TOP PRIORITIES

The second common method for cushioning against price drops involves implementing the equity component via a long/short position. Although this option is very easy to implement, it calls for more sophisticated in-house expertise than most institutional investors have so far been able to develop, notably selecting long and short components and managing net long/short exposure timing. This approach, therefore, generally involves outsourcing to a hedge fund manager.

Sceptics will invariably follow the herd instinct and urge everybody to stay away from these instruments, however the pros and cons should be looked at more carefully. The HFR Equity Hedge Index has held its own quite respectably against equity since 1990 and continued to do so in 2008. While it is by no means an absolute-return strategy (the marketing is misleading), it does offer an excellent equity substitute for investors that need to limit downside risk and are able to forgo some upside potential in order to achieve this. That said, the hedge fund industry urgently needs to do some homework here as outlined briefly below:

1) Since listed shares are liquid investments, hedge funds should also be tradeable and offer (at least)

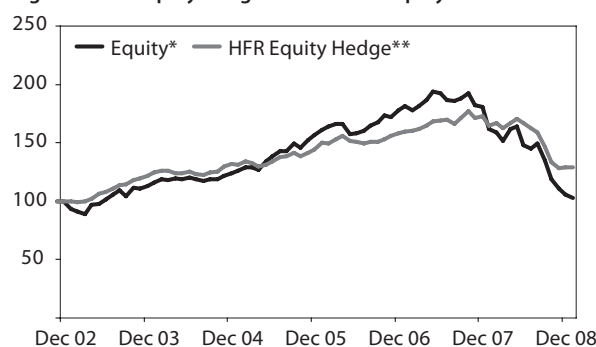
weekly liquidity

2) Transparent disclosure of the manager’s general long/short philosophy is essential (e.g. long value/momentum/mid caps, short index)

3) 2+20 with a threshold of 0 cannot serve as an institutional fee structure for a product that consistently contains 25–50% equity beta. Management remuneration of 0.75–1% plus 20% performance-based components – based on excess return compared to a reference portfolio that reflects the average long bias of the hedge fund manager – might be justified.

If the above improvements are carried out, we think that hedge funds will remain valuable components for enhancing the equity portfolio of pension funds. Perhaps regulators would be well advised to examine whether in this case equity long/short investments should feature in the equity component after all.

Figure 1: HFR Equity Hedge Index versus equity market



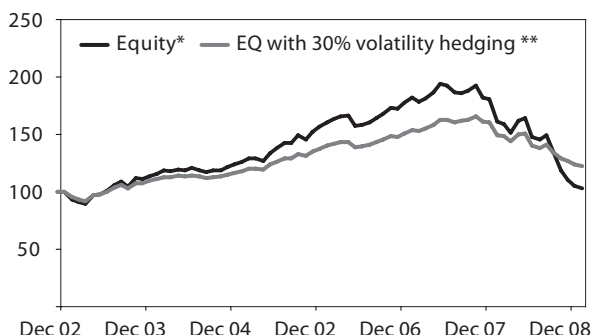
OPTION 3: INTEGRATION OF VOLATILITY STRATEGIES AS HEDGING COMPONENTS – EXPLOITATION OF NEGATIVE CORRELATION TO EQUITY MARKET

A less widespread hedging option involves hedging with volatility components. These components consist of products that purchase volatility and exhibit an inverse return profile to that of the equity market. In the event of high volatility (crises, bear markets) the hedging strategies generate high double-digit profits; when the markets are calm (stability, bull markets) they generally make no profit or break even. This combination also worked very well in 2008 and, unlike many hedge funds, paid off in line with expectations. An alloca-

Figure 1: *50% MSCI AC World & 50% MSCI Europe (after transaction costs) ** HFR Equity Hedge Index

tion of around 30% of the equity portfolio would have been enough to absorb a sizeable portion of the stock price falls.

Figure 2: Equities with volatility hedging component

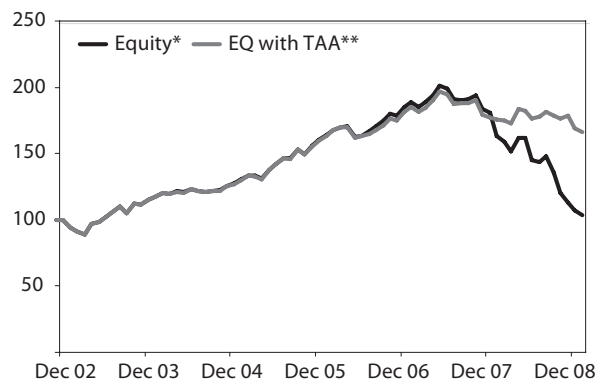


OPTION 4: TACTICAL MANAGEMENT OF EQUITY ALLOCATION – DISCIPLINE TRIUMPHS!

The fourth and last hedging option contains a well-known element – tactical asset allocation (TAA). This short-term control mechanism has not been developed and applied consistently enough in the past. Most (institutional) investors think of TAA as a regular quarterly meeting at which traders exchange personal and subjective market expectations. However, in most cases, it is clear that this approach generates minimal added value. Fortunately, the asset management industry has made considerable progress on this front. Nowadays, it is possible to derive very sound recommendations from quantitative models that monitor economic, technical and behavioural indicators. One need only think of the enormous success of CTAs in 2008. Wegelin & Co. uses a purely quantitative TAA model that it developed in-house. First implemented in 2005, this model also delivered valuable recommendations concerning the premature reduction of equity exposure in 2008. In mid-January 2008 the model clearly signalled that stocks should be underweighted and it continued to recommend this approach for virtually the entire year. An investor who managed his equity portfolio aggressively

in line with this signal would have been very well hedged against the market fluctuations. However, investors must get used to the fact that it is not enough to reduce their equity exposure by just 5–10%. A bold reduction of 50–75% of the entire equity portfolio is necessary if genuinely asymmetrical returns are to be achieved. Since this approach has only rarely been adopted by pension schemes and their regulators, it would make sense to discuss it in more detail in future.

Figure 3: Equities with tactical asset allocation (TAA)



SUMMARY:

Mapping asymmetrical equity returns is a great help for investors that are required to report their liquidity ratio annually and should therefore be investigated thoroughly. Providers of such strategies should be aware that products can only be implemented on a large scale once the transparency, liquidity and price of the hedge are appropriate. These requirements particularly need to be taken on board by the hedge fund industry and structured product providers. Tactical signals and volatility overlays are very flexible instruments since the equity position remains a component of the portfolio. Their implementation should be reviewed more frequently and consistently.

Figure 2: *50% MSCI AC World & 50% MSCI Europe (after transaction costs)

**70% equities (50% MSCI AC World & 50% MSCI Europe [after transaction costs]) + 30% volatility component

Figure 3: *50% MSCI AC World & 50% MSCI Europe (after transaction costs)

**100% equities (50% MSCI AC World & 50% MSCI Europe [after transaction costs]); for TAA signal to underweight: 25% equities + 75% Euro Bonds Index



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