Three months off the peak

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The road ahead remains rocky. Can an overlay manager help?

All was calm as we ascended the peak, with a faint whisper in the wind about a new sickness spreading in a remote province in China. As the weeks wore on, the wind picked up suddenly, and a faraway news story became a global COVID-19 pandemic--markets dropped into a freefall with very little warning. The world was quickly reminded of the power of gravity and how quickly things can go awry when footings are not stable. Eventually, we came to rest, but not without some notable injuries. Safety equipment—in this case, aggressive action by central banks and governments around the world—eventually stopped our perilous fall. Yet, we can probably all find things we could have done better in real-time to mitigate lasting damage to our portfolios.

Once markets bottomed in late March, we dusted ourselves off and quickly resumed our march upward. The rush of adrenaline still pulsing, most investors briskly pushed onward with the market rebound, in hopes of making up for lost time. Perhaps, though, we should pause for just a moment. What a great chance to take a deep breath and review not just where we are on the mountain, but the path that got us here.

We often remember challenging periods as having been much smoother in distant hindsight than the frenzy they really were in the heat of the moment. Instead of resuming business as normal, let's take advantage of the recent scare to think about the path forward. We have an important mission as an industry: to keep climbing for the betterment of our collective futures. We all manage portfolios funded to ensure economic promises to real people or ongoing commitments to lasting aspirational goals of great individuals and organizations that have come before us. Setbacks are a part of life—there is no straight path up. With that in mind, what have we learned recently on this journey? How could we better implement with an overlay?

Four key lessons learned

1. **Plan ahead for liquidity crunches** – Did fear set in or was it just the inconvenience of having to raise cash to fund obligations multiple times when markets were stressed? Those that could not rebalance at the end of March (due to liquidity concerns) missed an opportunity. In addition, transaction costs were elevated when cash was raised in crisis markets.

    a. *Potential Action*: Maintain higher balances in cash and highly liquid Treasuries. These balances can be overlaid with futures to achieve target investment exposures. If these liquidity account balances become large enough, consider an enhanced cash management mandate run in concert with the overlay and capable of pledging its more liquid assets as collateral.

2. **Correlation rises under stress, challenging diversification expectations** – When the market finally capitulated in March, nearly every asset fell except Treasuries. Those that had carved out a spot for a Treasury allocation benefited from a hedge against the equity decline and had an appreciated liquid asset to source cash from as well.

    a. *Potential Action 1*: Consider using the overlay to access long Treasury exposures in a capital efficient way. For now, there is still diversifying power in this trade of long Treasuries versus cash as well as positive carry—and the trade remains attractive while deflationary forces persist.

    b. *Potential Action 2*: Precious metals and mining exposures have been a topic of inquiry since the market rebounded. While gold and silver prices went down with other risk assets in March, potential benefits of holding them as a hedge against more lasting economic damage as the COVID crisis unfolds is an increasingly common theme. We are currently reviewing exposure alternatives of using futures, as well as ETFs, to access these exposures in a portfolio. As with oil markets, demand shocks from the crisis have led to more interest in precious metals, but in a different fashion than usual. We're seeing increasing retail interest in acquiring physical metals in conjunction with bullion production shutdowns—supply and demand are both impacted in a way that has moved prices upward recently. Our overlay team is still in the process of weighing the risks and opportunities for potential futures curve distortions due to physical delivery imbalances. More to come on that topic.

3. **Elevated volatility is more persistent this time** – Three months after the peak in the S&P 500 Index, implied volatility is still elevated. In early April, put insurance premiums had become prohibitive. Markets have since calmed, but implied volatility levels remain elevated. While concentrated mega caps have driven much of the market rebound, there is increasing dispersion among stocks. Pricing on implied index volatility has dropped in relation to that for single stocks. In addition, implied volatilities out near 2020 year-end are lower than the front end of the curve even after three months of healing, which is unusual. As a result, while time-value still decays from holding a put option as insurance, it is feasible that the implied volatility curve will remain mildly inverted out to the end of the year, removing another source of holding cost for those insuring with puts.

    a. *Potential Action*: As the market climbs, consider placing tactical put option hedges out to year-end. Selling a further out-of-the-money put option can reduce net premium, especially with higher-than-normal volatility skew. A wider spread between strike levels on such a put-spread hedge helps to increase the sensitivity to corrections, but also increases the net premium required. Setting a budget for protection premiums and having a clear picture of the extent of a potential market decline helps your overlay manager tailor a recommendation for your situation.

4. **Flexibility in asset allocation is critical** – Beyond the ability to rebalance in markets where physical movements may be challenging, there are ways to use an overlay to access exposures that might not otherwise find their way into the portfolio. We see a trend with investment policy statements allowing for moderate leverage. Our clients are increasingly realizing that leverage for the sake of increasing expected return and decreasing risk can be a prudent step. While many governance structures still prohibit any leverage, discussion of the benefits of controlled use of leverage belongs on the investment committee agenda. Financed in an overlay via futures or total return swaps, such positions can benefit the total portfolio, without impacting the traditional asset class exposures.

    a. *Potential Action 1*: Access long-dated Treasury bond exposures via futures or swaps on Treasury bond indexes.

    b. *Potential Action 2*: Access tail-hedging strategies via total return swap. Since this requires a more involved process than we can manage within our more generalist overlay team, we have sought and identified external expertise in this area. Utilizing a dedicated, specialist manager includes the edge of 24/7 monitoring and trading to maximize the capture of market dislocation opportunities. We prefer cross-asset hedges in this space, because hedges in volatility instruments (like VIX futures and options) tend to quickly give back gains as the market normalizes after a volatility spike. We believe a rules-based, dynamic strategy watching a broad universe of exposures increases the odds of finding correlation hedges to equity risk (compared to holding a single asset class such as Treasuries in a buy-and-hold fashion). Ongoing rebalancing is required due to shifting correlation relationships between assets. Alpha generation over time, in addition to a convex hedge response in market shocks, allows for longer holding periods than a more tactical option hedge.

    In such a strategy, long and short futures exposures are managed by a subadvisor within a prime broker environment. Account economics are then passed to the investor via a total return swap executed by an overlay manager, such that this tail-risk hedge can be added on top of the total portfolio (and does not require reducing exposure to current return-seeking allocations).

For all these reasons, Russell Investments has observed growing interest in derivative overlays from institutional investors. If you have an overlay provider in place, consider leaning on them more heavily to help better position for a bumpy road ahead without sacrificing longer-term investment objectives. If you don’t have overlay capabilities, now may be the time to consider a new manager relationship.

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