EQUITY RISK: CAN YOU LIVE WITH IT?

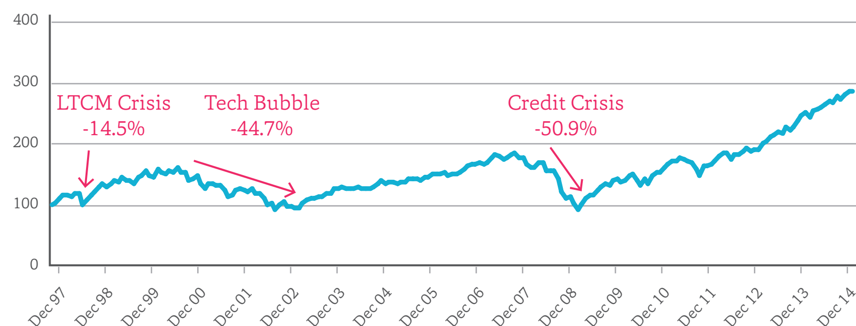
Institutional investors should consider managing equity risk to avoid events that may materially affect their financial position, preventing them from achieving their specific financial goals.

WHAT IS THE RISK?

Previous market shocks have led to significant losses on equity holdings and to long recovery periods:

- The level of the S&P 500 on the eve of the bursting of the Tech Bubble (August 2000) was only achieved again in October 2006.
- The level of the S&P 500 on the eve of the Credit Crisis (October 2007) was only achieved again in March 2012.

S&P 500 (TOTAL RETURN PERFORMANCE)



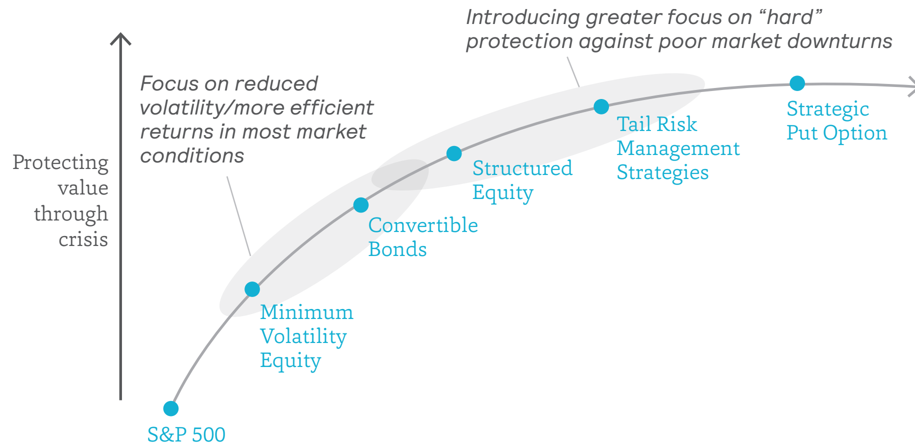
WHAT IS THE OPPORTUNITY?

Institutional investors are facing increasing solvency, risk, and liquidity constraints. As a consequence, interest in managing risks such as extreme downside equity is on the rise. In this context, there is a need to balance short-term risk budgets with the long-term need for return.

WHAT ARE THE APPROACHES TO MANAGING EQUITY RISK?

Several methods exist for managing equity risk to reduce losses through crises. These methods range from setting hard floors to focusing on low-volatility equity investments.

EQUITY RISK STRATEGIES



The strategies highlighted in the stylised chart above have historically offered different risk/return profiles and levels of protection during extreme events.

There is no single right answer, and, ultimately, the performance of any approach to reduce equity downside risk in a future market crisis will depend on the specific nature and drivers of that crisis (which cannot be predicted in advance).

WHERE TO START?

Our approach starts with developing a clear understanding of the specific objectives, beliefs, and constraints facing any given investor. This ensures that the discussion moves from investor needs to solutions rather than in the opposite direction.

RISK PROFILING

Designing and structuring an effective dynamic equity risk management strategy requires a clear, detailed understanding of an investor's risk profile, having regard to:

- Return needs and objectives.
- Tolerance for risk.
- Specific corporate or institutional context.

- Allocation to liquid growth assets, such as equities.
- Regulatory context.
- Governance structure.

INVESTMENT HORIZON

A key differentiator between equity risk management strategies is the investment horizon of the protection. Although providing a generic solution is difficult, the following strategies are common:

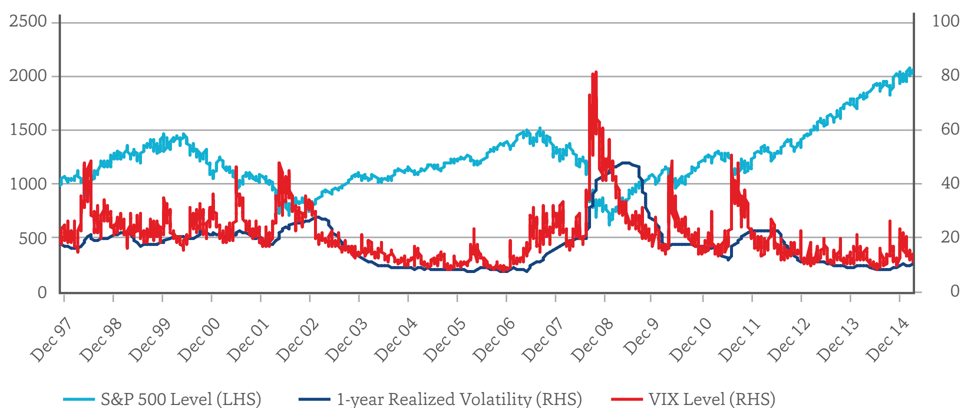
- Opting for hard floors and structured solutions to meet short-term risk limits.
- Allocating funds to low-volatility equity investments in the strategic asset allocation.
- Integrating both short-term tactical risk concerns and long-term investment return views in a dynamic framework.

WHY NOW?

The current market environment means it is relatively attractive for investors to consider approaches to managing equity risk:

- Equity markets have performed well in the past four years — the S&P 500 increased by 64% in USD — and investors may want to lock into these gains.
- The costs of various hedging and protection strategies have fallen in line with the fall in equity volatility. (The VIX index level has been hovering around 15% for the last three years.)

ATTRACTIVENESS OF CURRENT MARKET



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