EXPLORING ALL THEIR OPTIONS

Leading investors and consultants from the big super funds met to discuss option strategies and ***DISCUSS THE PRACTICAL AND MOST EMOTIVE ISSUES AROUND PORTFOLIO INSURANCE.***

By David Rowley *Photos* Phil Carrick

MANY INSTITUTIONAL INVESTORS rethought their approaches to downside protection after the GFC. For those investors with higher levels of governance, this has often meant the introduction of options to limit the downsides to equity market falls. The in-house investment team of Sunsuper started using options in 2009, while in the same year QIC started offering its services externally to other funds. Six years later, those funds have become more sophisticated in how they use them; Sunsuper uses them in dynamic asset allocation, while QIC now provides strategies for tail risk hedging, volatility trading strategies, and as well as acting as buyers and sellers of options too.

In the past two years, many other funds have introduced options internally, and the sharp falls in markets in January have seen some monetise options for the first time. Looking ahead, investors want options to provide protection in a world where they are pessimistic of both duration and diversification paying off.

PRIORITIES – TO PROFIT OR INSURE?

The funds participating in the discussion were asked to explain whether their option strategies were tail risk protection programs, or really a dynamic asset allocation bet.

The answers showed that for many, there is an element of both in their strategies.

Sunsuper uses options to make bets or to take downside protection on certain countries or regions in the global MSCI benchmark, or to go over or underweight asset classes or currencies. Alastair Sloan, head of dynamic asset allocation at Sunsuper, sees this as distinct from tail risk hedging, which he describes as "an overall portfolio hedge". He does not look to make a profit on such a tail risk strategy.

"I look at it as a binary bet and as something that's going to make me sleep easier, or actually give a defensive nature to a portfolio before it happens," he says. "In that way, you have an easier way of rationalising selling something on the way out, as opposed to gamma trading it and hoping to make money over time."

For the Mercer Super Trust, the use of options in its tail risk strategies is not permanent, and so arguably it could be described as a dynamic asset allocation bet. David Stuart, chief strategist, Mercer funds, says: "There are times when we would use it and there are times when we would say 'no it's not worth it, we can achieve what we want just using long only instruments'."

CLIENT OUTCOMES ARE THE END-ALL.
QIC

Similarly, others view options in tail risk programs opportunistically: Andrew Harrison, strategist at Vision Super, told how his fund had been close to monetizing its tail risk hedging portfolio in February; while Media Super, which commenced its put option strategy in July 2014, monetised its put option strategy in August 2015 and again in February this year.

Justin Nunan, investment manager at MediaSuper, is wary of viewing this as profit taking. He points out the value of the option strategy is a combination of both the options and the protection it gives to risk assets. In monetising, the fund may have made a profit on the options, but not necessarily on the overall strategy.

Gwion Moore, investment strategist at Suncorp, spoke of how options allowed insurance funds to get exposure to risk premiums in a way that was more efficient than investing in the assets themselves, particularly as insurance funds are restricted in the type of assets they hold.

Neil Williams, investment director at QIC, says that whenever a fund introduces or withdraws an option, it is changing its asset allocation by either raising or lowering their exposure to equities. This, he believes, should be factored into any decision. "If you think you've hit a level of the market where it no longer makes sense, or you want to realise the money that you've made on the option, then if you sell the option you are effectively raising your equity exposure," he says.

Michael Sommers, consultant at Frontier Advisors, agrees, and adds that the danger of switching out of options is that in a rapidly falling market, the alternative of dynamic asset allocation would not work.

"It's unlikely DAA is going to be quick enough," he says, adding that if options are already there, they do "all the heavy work" and should be favoured by the most risk-averse funds.

PARTICIPANTS

ANDREW HARRISON
strategist, Vision Super

GEORGE LIN
senior investment manager, Colonial First State

GWION MOORE
executive manager, investments, Suncorp

JUSTIN NUNAN
investment manager, MediaSuper

AONGUS O'GORMAN
senior investment consultant, Willis Towers Watson

ALASTAIR SLOAN
manager, dynamic asset allocation at Sunsuper

MICHAEL SOMMERS
consultant, Frontier

DAVID STUART
chief strategist - Mercer funds, Pacific, Mercer

ROBERT SWAN
head of liquid alternatives, QIC

NEIL WILLIAMS
investment director, QIC

UPFRONT COSTS ANXIETY-CAUSING

One of the most emotive areas for options is the upfront cost, which experienced users have come to look at in a philosophical way.

"Equities in history have generally gone up, therefore tail risk protections have generally in the past been unprofitable," says Sloan. "I have to have the mindset that my tail risk protection, hopefully, will add no value to my portfolio, because I want to think that the underlying assets in my portfolio are rising."

Moore sees such costs, or losses, as something that has to be explained to those governing the fund. "That's quite a fundamental thing to explain that you want to lose money on your hedges as the preferred outcome. Otherwise you get misunderstandings, and potentially quite damaging interference in the investment process," he says.

Robert Swan, head of liquid alternatives, QIC, advises it is important to differentiate between the option's expected return and its premium, as a focus on the latter can lead to unintended outcomes. "Over the long term, we would expect the return from passively buying options to be negative; however the magnitude of the return is not necessarily related to the premium," he says.

For Aongus O'Gorman, senior investment consultant at Willis Towers Watson, another governance headache is the expectation that sooner or later an option strategy will trigger a payout from volatility. This is not guaranteed. A slow drawdown in equity markets may not see any return on options. Another headache is the cost of options eating into already low projections for growth. In such circumstances an option replication strategy might be preferable.

GETTING THE BOARD ON BOARD

It was generally accepted in the discussion that the level of complexity around options was higher than conventional investment decisions. Furthermore, for a successful implementation, the executive and the board all need to be comfortable with the process.

Where boards are comfortable, it is common for investment committees to delegate authority to the chief investment officer with a brief that Michael Sommers summarises as, "Here's the framework and the objective we want. Here's the level of volatility. Do not lose more than X per cent in these scenarios."

"Transparency is important in building comfort," says Swan. "Spending time with the board – explaining how options work within a whole-of-fund context, what you will and won't do – ensures that you are setting realistic expectations."

Media Super is one such fund that has got its board and investment team comfortable with the use of options. The fund has a subset of its board and executives on a market disruption sub-committee that monitors the use of the options. Nunan says both executive

WE KNOW THAT GETTING THERE ISN'T OBVIOUS.
THERE CAN BE MANY OPTIONS.

QIC Limited ACN 130 539 123 ("QIC") is a wholesale funds manager and its products and services are not directly available to, and this communication is not intended for,

and trustees need to be comfortable with articulating the strategy easily, and that the secret to an efficient program is very clear rules, and capable partners.

This structure enables the fund to move quickly and decisively in the event of an exit from the program. "The entry strategy will be done in reasonably benign times as part of, probably, a longer-term program," says Nunan. "But the exit strategy will be done very much in non-benign times and needs to be done at a pace."

Sloan says the importance of an agreed plan on when to monetise options was illustrated by the difficulty of knowing where the bottom will be in market cycles. He gave the turbulence in January as a good example. "If you enter a tail risk strategy without an exit plan it's very difficult to determine when to monetise it," he says. "Similarly, if you go in with no tail risk strategy, your bosses will try to create an exit plan for you at that point in time as well."

The Mercer Super Trust uses a systematic alteration of its hedging levels according to market conditions as a collar strategy. "Put-buying is automatically reduced when volatility rises and the level of call-selling is reduced when volatility is very low," says David Stuart. "We would expect in major market moves to potentially adjust the strategy in a far more rapid and significant manner, if our views on markets were changing rapidly."

OPTION 'NEWBIES' MOST GUN-SHY

Funds that have not tried internally-run option programs can be the staunchest opponents to their use.

Here there is a tradition of using assets or trading styles that offer downside protection and a perception that options are an expensive alternative. There is also the belief that young members can withstand volatility in the long run.

One of the ways of getting such a fund comfortable with the use of options is to liken their use to the more mainstream use of currency hedging.

"If you are using currency options as an equity hedge, you have to compare the likelihood of achieving the same outcome as a plain vanilla put with the cost of the two approaches," says Neil Williams of QIC. "Whereas you put a currency position in your portfolio, most people forget about the hundred or two hundred basis points of carry you're actually paying out every year for diversification. I don't think it is often thought about in that way, in the same way an option premium is explicit."

The decision to use options can come down to a board's trust in its executive team, says Frontier Advisors' Sommers. "Some investment committees are quite hands-on and they will want to understand options, whereas others will say 'well I delegate that to you within parameters'," he says.

Colonial First State has yet to try options internally, +. and is equally sceptical of dynamic asset allocation.

"The challenge we find in buying any tail risk hedge is really the explicit cost, and secondly, the implicit cost in terms of the upside performance sacrifice," says George Lin, senior investment manager at Colonial First State.

His fund is benchmarked against competitors on a monthly and quarterly basis, and if a tail risk hedge is purchased too early, any upside performance that has been lost will stand out. Despite this, CFS is exploring a tail risk hedge and is considering the use of options or the use of hedge fund strategies for this. ✖

OPTIONS THAT DELIVER ARE THE ONES THAT MATTER MOST.
To learn more about QIC's tailored Options Solutions please visit www.qic.com
QIC
retail clients. For more information about QIC, our approach, clients and regulatory framework, please refer to our website www.qic.com or contact us directly.