INVESTMENT

How to protect from market corrections?

Mark Reinisch, Berenberg London - Asset Management, explains how a dynamic risk overlay can protect investors from market corrections

What is a dynamic risk overlay?

A cost effective way to protect specific asset classes in portfolios, normally equities, fixed income and currency, from falls in valuation as a result of market corrections.

Why do investors need protection from market corrections – equity markets are close to all-time highs, fixed income has risen in value for nearly a decade and currencies mean revert?

It is precisely because of the above that now is the time that investors should be looking to protect the gains that they have enjoyed from the record runs that we have seen in markets. Most commentators believe that markets are no longer cheap, and some believe that a sharp downward correction in both equity and bond markets is overdue. Whilst funds could reduce exposure, the opportunity cost of doing so if the march in markets continues would be painful and costly. A dynamic overlay allows funds to maintain cash exposure to markets, whilst using the futures markets to protect the capital value against general market falls.

How does a dynamic overlay work?

Dynamic overlay uses futures and OTC forwards to secure mid- to long-term market price risk. Unlike a static hedge, which constantly secures the full exposure, the hedge ratio is actively managed. It is increased when the underlying depreciates and decreased when the underlying appreciates. Thereby, an asymmetric risk-return profile can be achieved that limits market price risk and allows investment gains.

Can investors not achieve the same result more simply and cheaply by using put options?

Put options can certainly protect portfolios in the same way as a dynamic overlay. However, there is a fundamental difference between using futures and options that impacts on the price that the investor pays. An option is priced based upon the implied volatility of an asset, whilst a future is priced off the realised volatility. As implied volatility is almost always higher than realised volatility, the cost of an option-based strategy is almost always higher than the cost of a dynamic overlay.

Where can investors use a dynamic overlay?

Any asset that has a liquid futures market associated with it can benefit from a dynamic overlay i.e. most developed and emerging bond and equity markets, gold, silver oil and most commodities. Additionally, through the use of forward currency contracts, dynamic overlay is also employed to protect against falls in foreign currency destroying the returns of an overseas asset when translated back to a home currency. This is dynamic currency hedging.

When does a dynamic overlay not add value?

As a trend following strategy, the dynamic overlay works best when there is a clear trend in place – be it upwards or downwards. The time when the strategy can detract from performance is in range bound markets with no clear trend up or down. Many investors regard this as the time when they pay the ‘insurance premium’ for the protection they will receive when they really need it in a falling market.

You mentioned currency and dynamic currency hedging – why replace an existing passive currency hedge?

Whilst a passive currency hedge will protect an overseas asset against loss of market value caused by a decline in a foreign currency, it precludes any benefit from an appreciation in the overseas currency. Additionally, when a foreign currency that is subject to a passive hedge appreciates, the resulting loss in the hedged position (the difference between the exchange rate at which the asset is protected and the new, higher exchange rate at the end of the contract) is settled in cash. These cash flow losses can be significant. By using a dynamic approach, where the only input into the process is the underlying exchange rate, the opportunity to avoid losses and participate in gains caused by currency movements is far greater than when using a passive approach. ■

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