Russell Research

Adam Van Ness, Head of Transition Portfolio Management, and **Tom Fletcher**, Managing Director, Overlay Services, explain a strategy designed to limit equity losses but not the upside potential.

JANUARY 2012

Downside Protection: a practical pre-transition solution

The spikes in volatility this summer and the continuing debt crisis in Europe will have heightened tensions in the pension's world. The increasing volatility, coupled with decreasing equity return expectations, has come at a time of record low bond yields and funding concerns amid many pension funds. With corporate, industry, and government funds alike considering de-risking strategies, many observers comment that this may not be the most optimal time to be reducing equity assets and the potential time it may take to develop a comprehensive transition strategy may be prohibitive. But what other alternatives are there? Though one can attempt to increase returns by capturing the premiums associated with long volatility options strategies, one alternative to transitioning equity assets considered here is "Downside Protection".

Russell's Downside Protection (DP) overlay service is designed to limit losses in the event of large equity market declines, whilst not limiting upside potential by being out of equity markets. DP allows up to 70% of the equity allocation to remain in place with current managers. The residual equity exposure is delivered by long or short positions using futures so that the client maintains the required exposure to the market. Over the course of the protection period, the program will vary the amount of equity exposure based on market movements and volatility conditions.

The Destructive Impact of Large Declines

By limiting the losses from major market declines, wealth compounding and risk-adjusted returns are greatly improved. Avoiding just the largest wealth declines can provide significantly higher wealth accumulation than even higher rates of return or alpha.

Previous downside protection strategies have had numerous shortcomings: 1) focus on protection at the expense of upside capture 2) lack of responsiveness to changes in market conditions 3) and inflexibility with input factor changes over time. These drawbacks were unattractive to most clients since they required high up-front costs, eroded compounded returns or did not account for local market nuances. While there are no free lunches (i.e. all upside and no risk), Russell's DP strategy provides a new approach to achieve a significant reduction in wealth destruction associated with large downturns while maximising upside capture.

How the strategy works

Russell first discusses desired risk levels with each client. A downside floor is set, as is the probability of breaking that floor per the client's needs. An example would be an 80% floor for asset value declines, and a 5% probability of reaching the floor. As the market moves, the targeted equity exposure (0 – 100%) moves to hold the probability at the input level. Target equity exposure is achieved with a combination of existing manager exposures and futures trading. Russell's DP overlay is an ongoing assignment that protects a floor level in each fiscal year period. Both the floor and acceptable probability (client's risk inputs) can be changed over time as the client's needs change. By limiting the severity of loss in any given period, the strategy behaves as a form of time-based risk budgeting. Having an ongoing futures program also shortens reaction time and allows for protection early in the market correction, rather than reacting in hindsight after the damage. In times of extreme volatility, this strategy may even limit equity exposure at the reset of a new protection period if the chosen probability is not attainable with a 100% equity allocation. Conversely, full exposure to the market is expected in a calm market with upward momentum at the point of reset. Thus, Russell's DP overlay does a better job of matching equity exposure to the investor's loss tolerance – adding equity exposure when market risk is low and reducing equity exposure when market risk is high. Importantly Russell's approach is a dynamic one, unlike a typical Constant Proportion Portfolio Insurance (CPPI) strategy, and is more customisable.

Benefits of Russell's strategy

Russell's strategy considers changes in the risk level of equity markets. In addition, Russell's strategy does not face an upfront hedging cost in each year like option-based services. Russell's hedging strategy depends upon volatility and the returns experienced by the client. Hedging costs are driven by the volatility and market price path of the assets being protected. In low volatility and upward price trending markets, the strategy requires less trading. In downward trending, more volatile markets, trading costs increase with higher turnover – this should be expected as trading is required to help reduce risk through hedging. Since this program functions to offset negative skew in the distribution of returns of unhedged equity, the program not only limits the major market declines, but can also reduce the magnitude of a decline that is not as extreme as the specified floor. Furthermore, Russell's process uses control bands to limit turnover from daily market noise -- considerably reducing trading costs with little perceivable impact on the protection offered.

The end of the journey depends upon the beginning

Avoiding outsized losses is crucial to a beneficial investment outcome. When a large downturn occurs early in the longer time horizon of the assets backing an ongoing pension obligation, the compounding effect is further magnified. A 50% loss in the first period requires a 100% gain in the next period, just to break even! Russell's Downside Protection overlay service helps investors preserve their capital even in tough market climates. If a journey of 1000 miles begins with the first step, those first steps would do well to avoid holes.

For more information:

Call Russell on **+61 2 9229 5111** or
visit **www.russell.com.au/institutional**

Important Information

R_RPT_RES_DownsideProtection_V1D1_0112

First use: May 2011 (rev. Sep 2011, Jan 2012). MKT/4302/0112