FAMILY WEALTHREPORT

GUEST ARTICLE: Winter Is Coming, But Will Portfolios Be Ready?

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August 3, 2017

What will the economic "weather" bring in the months to come and what sort of considerations should investors have? A chief investment officer at a multi-family office seeks some answers.

The following article is by Justin Pawl, partner and chief investment officer of Covenant, a Texas-based multi-family office. He takes a look at whether investors are ready for any turns in the state of markets.

The editors of this publication are pleased to share these views with readers; they don't necessarily endorse all views of guest contributors and invite readers to respond. Email tom.burroughes@wealthbriefing.com

Since the first episode of Game of Thrones, characters have been predicting that "winter is coming." Yet, this particular subplot of the epic storyline has remained in the background, as the ruling families focused on other significant short term challenges. But now as the show enters its penultimate season, the imminent threat of winter is forcing many characters to respond.

There is a clear analogy to today's investment environment. Equity investors today face a significant challenge. As the bull market for equities extends into its ninth year, many investors are wondering how long it will continue before a major market correction occurs. And while the timing of a potential market "winter" may not be as clear as it is in the show, investors are hoping they don't get caught unprotected in the potential coming storm. More than that, investors are wondering how to protect their equity exposure when a market "winter" arrives. Maintaining equity exposure while simultaneously protecting against an eventual drawdown is today's key market challenge.

Historically, there have been several ways to protect portfolios against a bear market in equities. The list includes market timing, asset class diversification, derivative based strategies, and alternative investments, to name a few. However, they each come at a price and there are reasons they may be less effective in today's environment. Market timing is unlikely to work because there's too much opportunity cost in being wrong or too early.

Said differently, re-allocating equity risk to cash and waiting out the storm isn't a realistic option - after all, there's no telling how long the bull market could last. Asset class diversification may help, but several years of significant monetary stimulus have created the potential for overvaluation in multiple markets, not just equities, and previous diversifying relationships may not hold. As an example, it is not hard to imagine a scenario where equities and high quality bonds underperform at the same time, given the historically low starting point for interest rates. Derivative based strategies - such as buying trailing puts - can be prohibitively expensive, unless you get the timing right. Finally, alternative investment vehicles like hedge funds may work, but most strategies are not diversifying enough.

Given that these conventional solutions may fall short, perhaps it's time investors consider a different approach - using equity market volatility itself as a tradeable asset class.

Before looking at specific strategies, it's helpful to review how volatility is priced in today's market. Many investors have lost perspective on what real long-term volatility historically looks like. According to *Bloomberg*, 2017 year-to-date realized volatility for the S&P 500 Index as of 7/31/17 was approximately 7 per cent annualized. Implied volatility, a reflection of market expectations using the VIX Index - a weighted average of implied volatilities from the individual S&P 500 constituent option markets - has similarly collapsed to multi-year lows recently, just above 9 per cent. As a long-term frame of reference, these numbers compare to realized and

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implied volatility for equities that have been in the low to mid-teens during most of the last 40 years. Single digit equity volatility is unusually low.

Translating the impact of this to what investors have experienced, the low volatility combined with strong equity returns has meant unusually high risk adjusted returns. Specifically, according to Bloomberg as of 7/31/17, the Sharpe ratios (excess return vs cash, divided by volatility) for the S&P 500 index for trailing 1, 3, and 5 year periods were 2.00, 0.96, and 1.57. This compares to long term Sharpe ratios for equities of less than 0.5. These elevated risk-adjusted returns have created a distorted sense of what's possible going forward for many investors. To the extent Sharpe ratios revert to long-term averages, through either lower returns or higher volatility, or both, we see an opportunity. The reliably inverse relationship between equity returns and the level of expected market volatility provides the possibility for a new source of protection.

The emergence of volatility as a tradeable asset class in the last few years is evident in the impressive surge in VIX futures trading volume. According to the Chicago Board Options Exchange, average daily volume in VIX futures has jumped from $17 million notional to $239 million between 2010 and 2016. The evolution of the VIX Index as a straightforward measure of equity market "fear", and the subsequent growth of VIX futures as a direct way to harness this measure, together offer a new way to hedge. At the same time, we believe this new market requires expertise - specifically a manager with a pedigree that reflects a research based fundamental approach to modeling and understanding the factors that drive equity and volatility related instruments.

Pulling it all together, with the right manager and strategy, equity market exposure can be combined with active long volatility futures exposure to provide a creative way to address the dual objective of positive market risk with the potential for downside protection. To meet this dual objective, we have chosen the Context Strategic Global Equity Fund (I-Share Class: CGPGX) for our liquid portfolios, which is a global equity fund that primarily uses developed equity index futures with a modest value tilt, and a volatility-based risk mitigation overlay. Under normal conditions, the fund maintains at least 80 per cent of its exposure in developed equity markets, while employing active and variable long volatility futures exposure that offers potential for downside protection. Importantly, the manager's background reflects significant experience in the field, managing both equity and volatility related instruments used in the fund.

CGPGX is just one of a growing number of liquid alternative mutual funds that combine an equity-focused strategy and a volatility based component also. These types of dual strategies can also fit nicely into an investor's portfolio. In our case, we sold primarily global equity exposure and also some alternative investment exposure to fund the allocation to CGPGX. While by no means a panacea, we view CGPGX as a strong way to target our two potentially conflicting objectives - upside potential and downside protection.

Winter is coming, we just don't know when. Investors can take steps now to prepare for winter's potential arrival by allocating to strategies that provide both equity exposure and downside protection through volatility related instruments at minimal cost. While the timing for this kind of strategy is good now that volatility is low, its use reflects something more. The growth and acceptance of volatility related instruments suggests a fundamental market shift – an expansion of the non-equity market choices that can be useful as ballast against equity market underperformance. Skilled practitioners have rushed to understand and make use of its characteristics as a solution. Strategies that take advantage of this development deserve a place in investors' portfolios, alongside the traditional list of other potential solutions.

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