Hedging in a New Volatility Environment

Strategies for Client Portfolios

In BigSur's Thinking Man #43 (published August 8th, 2016), we spoke about effective and inexpensive strategies for hedging investment portfolios in that world of quantitative easing, both for the short and long term.

Now that QE is slowly being un-winded and interest rates are beginning to normalize in the U.S., the hedging environment has shifted too. The February market correction officially put an end to the age of low volatility.

Realized volatility in the S&P 500 index averaged an annualized 6% for 2017, compared to 19% for the first three months of 2018. Given this new volatility environment, we have decided to revisit the topic for clients to better understand what hedging strategies are available in the toolbox.

In this Thinking Man, we present actionable investment ideas for minimizing and mitigating losses during uncertain and volatile periods of time. While some clients opt to sell a portion of their equities portfolio, others prefer to stay the course, but in a better risk-adjusted manner by hedging and investing in defensive securities. Here is a summary of the hedges discussed:

Hedge Assets	**Effectiveness**	**February Sell-Off Performance** (with the SPX down 4%)
Gold	High	Gold up 0.25% (highly effective in longer periods of uncertainty)
Gov. Debt (Treasuries / JGBs / Bunds)	Low	Treasuries up 0.50% / JGBs up 0.10% / Bunds up 0.25%
Hedge Currencies	**Effectiveness**	**February Sell-Off Performance** (with the SPX down 4%)
Japanese Yen (JPY) / Swiss Franc (CHF)	Medium	JPY up 0.80% / CHF up 0.40%
Portfolio Overlay Hedging	**Effectiveness**	**Commentary** (sell-off performance varies by contract)
Protective Put Options (SPX)	Medium	Option terms dependent, too expensive to implement today
Short Futures (SPX, DAX, Nikkei)	High	SPX Short Futures up 4% (near perfect hedge), Futures broker req.

*All performance averages were calculated using data from the two days of largest sell-offs

Hedge Asset: Gold

Demand for gold increases when there are "fear factors" in the market. Gold is often viewed as a hedge against certain extreme outcomes, simultaneously offering protection against unexpected inflation, currency debasement, financial system failures or crises, and geopolitical unrest.

The "normal" relationship would say that gold should fall as real rates rise, since as a non-yielding asset there is less reason to hold gold in a higher rate environment. Since the beginning of the year though, we have witnessed an increase in the value of gold in sync with a rise in treasury yields.

The Thinking Man's Approach

April 2018 | Series #57

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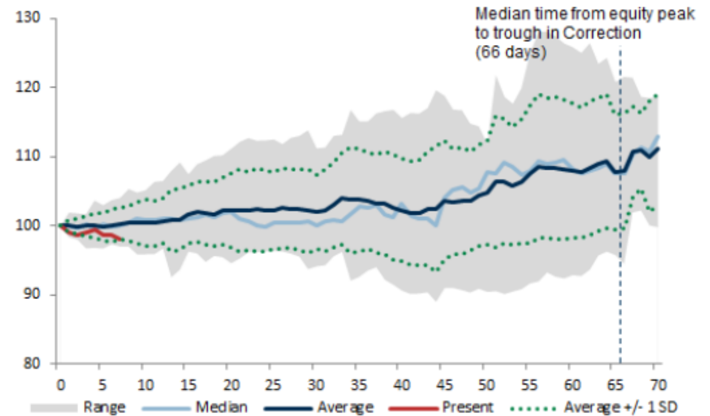
- The February market correction officially put an end to the age of low volatility, therefore we are exploring new hedging strategies.
- Gold is a strong hedge against systematic risk – historically gold has been up 7.5% on average when the market reaches its trough.
- Government debt from the U.S., Japan and Germany is often considered the ultimate safe-haven asset by investors in "flight to quality" scenarios.
- Safe-haven currencies are described as those with ample liquidity and stable political and economic systems. Both JPY and CHF have been fulfilling their hedging roles.
- Volatility is no longer cheap, therefore we prefer shorting SPX, DAX and Nikkei futures rather than buying puts.

For more on how we are positioning our portfolios, please contact your investment advisor or: ideas@bigsurpartners.com

According to Goldman Sachs Research, in the first 30-40 days of an equity sell-off, the average hedge response of gold tends to be quite small, but by the time the market has hit its trough, historically gold has been up 7.5%.



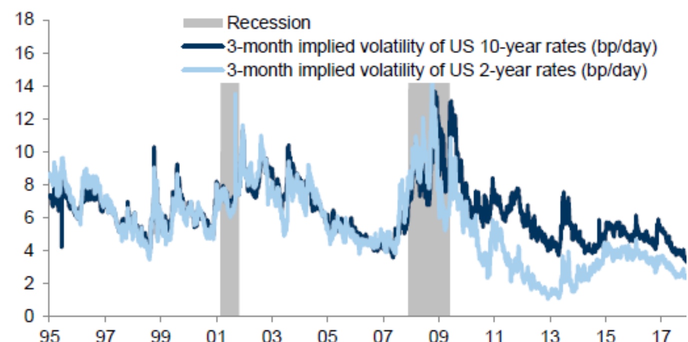
Gold tends to underperform other safe-haven assets in the short-term, usually taking a month or so before starting to act like a true hedge.

The reason for this is that gold is primarily a hedge against systematic risk – therefore if a sell-off is technically-driven (as we believe the February correction was) instead of fundamentally-driven, it will protect a portfolio but to a lesser extent than if it were a longer period of uncertainty.

We believe the macroeconomic outlook remains strong, especially with S&P 500 earnings expected to grow more than 18% from Q1 of the previous year (driven by tax reform), but that by the end of the year, the market could reach its peak growth rate. For this reason, we believe it makes sense to add gold exposure for the short-to-medium term as a protective play.

Hedge Asset: Government Debt

Fear in the market leads investors to question their risk exposures. In a "flight to quality" scenario such as the one we saw in February, traders flee from equities and pour into less risky, yet liquid investments such as U.S. Treasuries, Japanese Government Bonds and German Bunds.



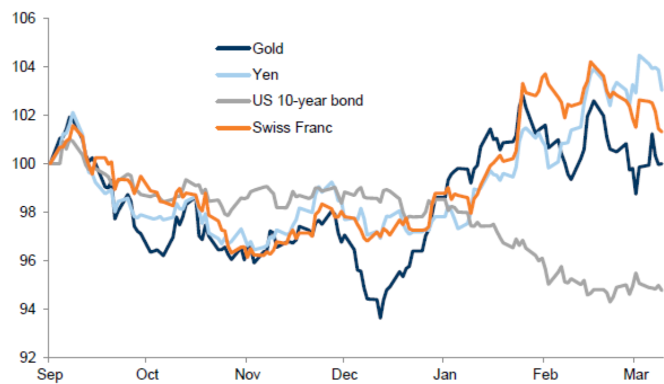
Government debt from the United States, Japan, and Germany is often considered the ultimate safe-haven by investors. In times of global turmoil, uncertainty, and market volatility, investors flock to quality assets backed by these developed governments, who they believe have little to no risk of default.

It is important to keep in mind though that government debt is not as effective as a hedge today as in the past given the lower rate environment. Additionally, although these government bonds are amongst the safest investments, they are not risk-free. In a rising rate environment, prices will come down – this risk could be offset by selling a futures contract on the position.

Hedge Currencies: Japanese Yen (JPY) and Swiss Franc (CHF)

Safe-haven currencies are fundamentally described as those with ample liquidity, stable political systems, strong country finances, and stable economic backdrops. Arguably more relevant is that safe-haven currencies are safe-havens because investors define them as such and everyone knows that they will be flooded with flows in risk-off environments – negative correlation with equity returns and positive correlation with bond returns and market risk changes.

On top of that, there may be technical factors at play. The Japanese Yen (JPY) has been the global funding currency of choice for investors, as the Japanese economy has been in deflation for over 20 years and it has offered the lowest interest rates in the world. This implies taking a short position in the yen and when the "risk-off" trade is on, many of these trades are unwound, which generates an abrupt short covering rally. The Swiss Franc (CHF) has always been considered the safe-haven of Europe, thanks to its neutrality, economic and political stability.

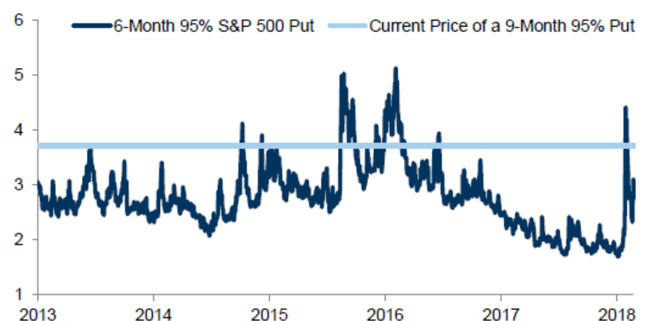


Both the Japanese Yen (JPY) and the Swiss Franc (CHF) have been fulfilling their hedging roles in this latest market sell-off. The graph to the right shows that after the February sell-off, these safe-haven assets rallied.

Portfolio Overlay Hedging: SPX Protective Put Options & SPX Futures

The price for buying Puts on the S&P 500 had fallen to record low levels last year, while equity markets traded at all-time highs. Clients will remember us telling them repeatedly "volatility is the only cheap asset", and we were right. The low levels of volatility in options markets offered our clients the opportunity to build protective positions with completely asymmetric pay-offs. Even when some hedges failed to work, they allowed investors to stay long despite rising valuations.

This is no longer the case today given the end of the low volatility era – protective Puts have become too expensive to implement (see graph).



Because of this, we are instead recommending clients to short index Futures. Futures are more effective than Puts given their "near perfect" inverse correlation with market movements. Clients can stay invested without needing to sell equity, allowing them to avoid transaction costs and tax implications, and these protective hedges can be executed with great speed and ease (even outside of regular market hours). Depending on the geographic composition of equity portfolios, we recommend shorting SPX (U.S.), DAX (Germany) and Nikkei (Japan) Futures accordingly.

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