Solve for Next: Preparing for Equity Regime Changes

Key Ideas

Traditional reliance on public equities for long-term returns is being challenged by increasingly volatile markets and frequent regime changes. With lower expectations for return-seeking assets, investors seek diversification and risk mitigation strategies that don't compromise growth potential. Traditional equity mandates can be rigid, and adjusting positions to meet this goal can be challenging, but integrating a modest alternatives allocation provides potential solutions. Among these, one solution shows the potential for consistent outperformance during severe declines while maintaining the ability to generate alpha in a recovering and rising market – a promising option to improve long-term outcomes in all types of market conditions.

In this paper, we will:

- Explore the limitations and challenges associated with traditional equity strategies in the context of increasing market regime changes.
- Compare and contrast the potential integration of alternative asset classes, including futures and options, to augment traditional strategies within equity allocations.
- Make the case for integrating futures with traditional equity strategies as a way to increase returns, improve diversification, and enhance the overall risk-return profile.
- Address practical considerations for the best implementation approach.

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In our previous paper, *Revolutionizing Equity Strategies for a New Frontier,* we outlined in some detail the time-varying risks, in the form of increased volatility, more frequent and more violent drawdowns, and breakdowns in asset-class correlations, that pension funds may have to face moving forward. Here, we'll focus on the limitations of existing approaches to equity allocations, along with what alternatives may be available to navigate an increasingly perilous equity landscape. Ultimately, the objective is to offer a strategic approach to improve long-term outcomes – over all markets and all seasons.

The Limitations of Traditional Equity Strategies

Pension funds have traditionally relied on equities as a primary source of returns due to their potential for long-term growth. However, the limitations of this approach have become evident in the face of changing market dynamics. Traditional equity strategies are susceptible to heightened volatility and vulnerability during market regime changes. The correlation within equities and across asset classes can shift abruptly, wiping out diversification benefits. Moreover, lower return assumptions have pressured pension funds to find sufficient return sources to meet their long-term obligations. Consequently, there is a growing recognition that traditional sources of growth are becoming less suitable.

After over a decade of unprecedented fiscal and monetary policy intervention, macro threats are increasing the frequency of market regime changes, posing significant challenges for pension funds. These changes can be triggered by various factors, including economic recessions, geopolitical events, policy decisions, and technological disruptions. Such shifts can lead to increased market volatility, heightened systemic risks, and amplified correlations among equities – and worse – among other traditional asset classes. Pension funds that rely on equities as the main source of growth (and risk), while investing in other asset classes as diversifiers, face greater vulnerability in this emerging environment.

The frequency of these market regime changes has amplified the importance of effectively managing these risks. Recognizing the limitations of traditional equity strategies, investors need new ways to augment their investment outcomes.

Common Instruments for Navigating Macro Threats

Deploying futures or options are common ways to mitigate and exploit the short-term risks presented by macro threats. They offer unique risk and return characteristics: the potential to generate returns that are less dependent on traditional equity markets, while mitigating time-varying risks through diversification. An ideal complementary alpha source would improve equity outcomes, crucially, without materially changing the long-term characteristics of the equity mandate, thereby allowing investors to retain investment policy benchmarks.

For this paper, we'll focus on these methods and their direct relationship to equities, which may make them more appealing than increasing portfolio allocations in less-correlated, but also less-liquid, investments such as real estate, private equity, and infrastructure.

Strategy	Characteristics	Advantages	Disadvantages
Options	A derivative contract that offers the right to buy or sell an asset at a specific price on or before a certain date.	1. Offers potential for high returns. 2. Can be used for hedging and speculation. 3. Wide variety of strategies available.	1. Can be complex, expensive, and difficult to understand. 2. Subject to time decay, which erodes value as expiration date approaches. 3. Potential for total loss of investment.
Managed Futures	Contractual agreement to buy or sell a particular commodity or financial instrument at a pre-determined price in the future.	1. Can be used for hedging with exposure to asset classes outside equities. 2. Extremely cash-efficient where low capital and high leverage can amplify returns. 3. Extremely cost efficient.	1. Leverage can also amplify losses and lead to margin calls. 2. Complexity requires active management.

Options: Flexibility and Downside Protection

Options are derivative contracts that provide the holder with the right, but not the obligation, to buy or sell an underlying asset at a predetermined price within a specific time period. They offer flexibility in constructing investment strategies, allowing investors to tailor their risk and return profiles according to their objectives, including downside protection. However, options have many drawbacks, making their application in risk management challenging (Figure 1).

FIGURE 1
CHALLENGES WITH OPTIONS TRADING

Complexity	Options trading can be complex, especially for multi-leg strategies, and require professional expertise. Mistakes due to complexity can result in losses.
Transaction Costs	The costs of trading options can be high, particularly for the active trading required to hedge short-term risks. Costs include spreads, commissions, and platform fees.
Time Decay	Options are subject to time decay – unique to options – which erodes their value as the expiration date approaches.
Total Loss Risk	Options trading entails the potential for a total loss of the investment if the option expires worthless.
Liquidity	Options on less popular stocks or indices can suffer from poor liquidity, leading to wider bid-ask spreads and potential difficulties when entering or exiting positions.

Futures: Return Convexity and Alpha Source

A strategy employing futures can provide exposure to a variety of asset classes, such as equities, fixed income, commodities, interest rates, and currencies via both long and short positions in futures contracts. This diversification potential can enhance portfolio returns by capitalizing on diverse market opportunities.

Futures inherent leverage makes them cash-efficient, requiring a relatively small allocation to cash collateral to make a significant impact on the portfolio. Historically, managers using futures have typically provided positive *convexity* of returns, or greater outperformance during the worst drawdown periods (see Figure 2). Additionally, futures are not subject to time decay, but options lose value over time, meaning managers have to roll their positions constantly. This can be a costly and time-consuming process that can be avoided by using futures. Compared to options, futures also have lower transaction costs, including commissions and bid-ask spreads. The cost advantage can be significant, especially for strategies that benefit from frequent trading activity from macro shocks and exogenous risks.

The primary drawback of incorporating futures is that they require particular expertise to execute successfully, but skilled managers have demonstrated the ability to post consistently high Sharpe ratios using these instruments. We believe they represent the best tool available, given the risks facing modern markets, and we'll explore the attractive combination of potential benefits futures bring to the table in the next section.

FIGURE 2

ROLLING 3-MONTH EQUITY RETURNS VS. MANAGED FUTURES RETURNS

2000-01-01 to 2023-03-31

Source: BarclayHedge and FTSE Russell

Managed futures index is the SG CTA Index. Source: BarclayHedge for SG CTA Index and FTSE Russell for Russell 1000 Index. The data presented reflects past performance, which does not predict future returns. For illustrative purposes only.

What about Convertibles and Low Volatility Equity?

Convertibles: Hybrid Securities for Equity Participation

Convertible securities are hybrid instruments that possess both debt and equity characteristics, providing the holder with the option to convert a fixed-income security into a predetermined number of common shares of the convertible bond issuer. They offer investors the potential for equity participation, capturing the upside potential of the underlying stock, while providing regular income in the form of a coupon. They can be attractive substitutes for a portion of an equity allocation, especially in periods of high market uncertainty. However, the universe of convertible securities is relatively small compared to the broader equity market, making liquidity a concern for some issues. And while their hybrid nature provides a combination of some of the benefits of bonds and stocks, it also combines some of their risks: rising interest rates can decrease value; issuer credit ratings may decline; they typically come with a lower yield than their equivalent straight corporate debt, but may never pay off to the upside if the share price doesn't rise; and shares may be diluted at conversion.

Low Volatility Equity Strategies: Reducing Downside Risk

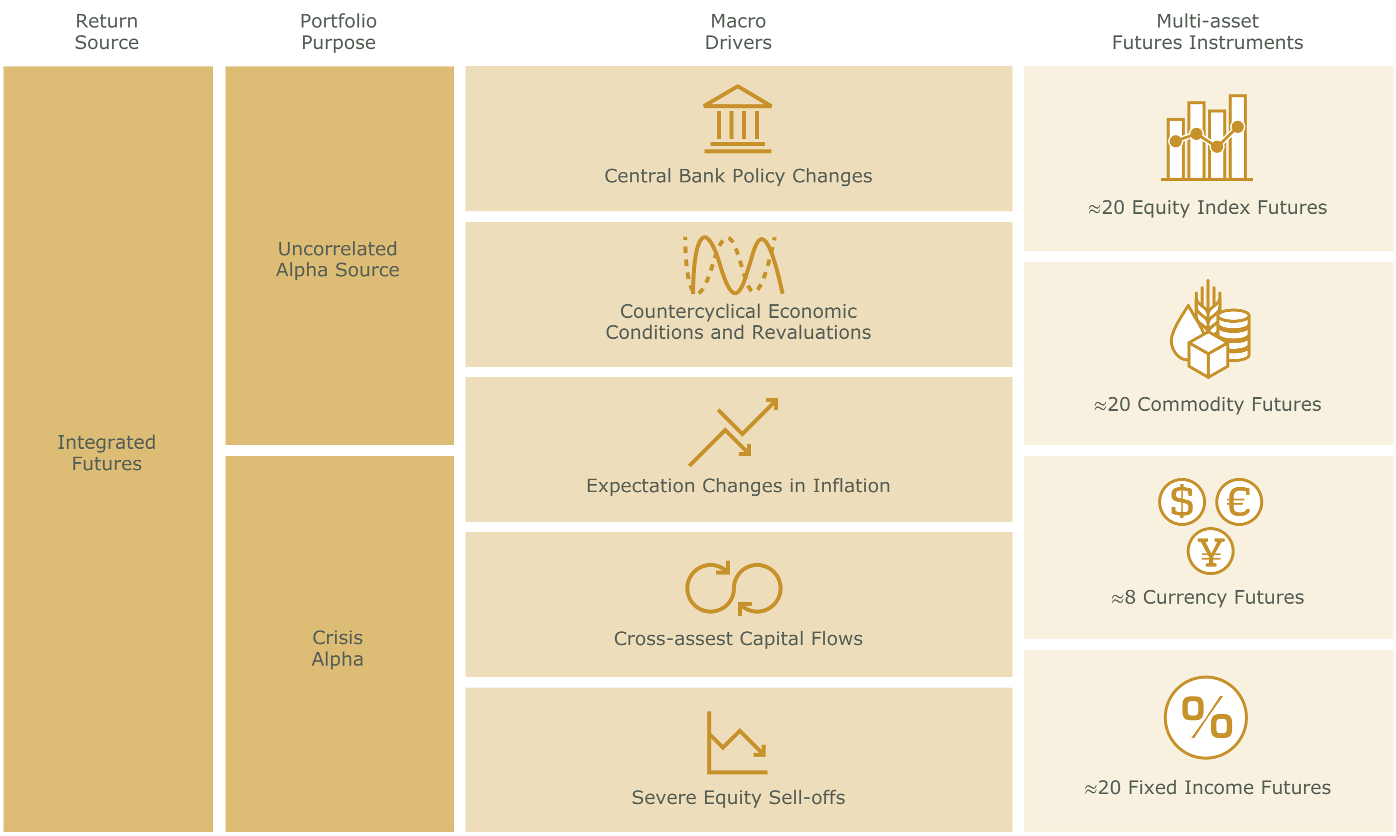
Low volatility equity strategies focus on creating stock portfolios with lower volatility compared to the overall market, either by screening for low volatility stocks, or combining stocks in a low volatility portfolio via optimization. With shrewd portfolio construction, low volatility equity strategies can offer protection against market downturns while still allowing for equity market participation over the long run. However, it's important to note that low volatility equity strategies may have lower upside potential during bullish market phases, resulting in potentially long periods of underperformance before they have the opportunity to catch up during a downturn. The last 10 years illustrate this point well. Despite some significant drawdowns, both MSCI's USA and World Minimum Volatility indexes have trailed their cap-weighted counterparts by 153 and 146 bps annualized (through the first quarter of 2023), respectively, as they failed to adapt to shorter-duration drawdowns within a longer bull market. What's more, they also may not perform as expected in the sharpest of drawdowns and recoveries, as correlations and risk profiles among individual securities break down during black swan events.

Why Implementing Futures Make Sense Across a Variety of Time Horizons

Effectively incorporating a diversified, long-short basket of multi-asset futures into an equity portfolio offers return opportunities, mitigates macro risk, and protects during drawdowns. This makes them an attractive option for diversification within a pension plan portfolio looking to improve risk-adjusted returns. This risk-adjusted return optimization is mainly due to the ability of futures trading to perform well in both upward and downward trending markets, with effective signals based on changing market conditions. This is possible by taking successful long and short positions in futures contracts on commodities, interest rates, currencies, and equity indexes, providing a level of flexibility difficult to achieve with traditional allocations to asset classes (Figure 3).

FIGURE 3

INTEGRATED FUTURES' MACRO VIEW UNLOCKS POTENTIAL FOR HIGHER, MORE CONSISTENT ALPHA



Further enhancing their attractiveness as a diversification tool is that successful futures implementation tends to perform best during periods of heightened volatility or uncertainty, which can often coincide with periods of equity drawdown. This is where successful managers have earned their reputation for return convexity, also aptly known as “crisis alpha.” The trend-following nature of such actively integrated futures programs can potentially allow them to capitalize on periods of uncertainty and serve as a hedge against equity market downturns. To summarize their primary potential benefits:

1. Enhanced Returns: Successful implementation of long and short futures in different asset classes can potentially provide an additional source of return that is uncorrelated with equity markets. This can help improve the return of the overall equity portfolio when market regime shifts make active equity management more challenging, potentially leading to greater accumulated benefits for plan participants.

2. Reduced Volatility and Downside: Incorporating a futures component can also help reduce the overall volatility of the equity portfolio, due to the low or even negative correlation with equities. This can make the plan’s investment performance less dependent on the performance of the equity markets, potentially reducing the impact of any downturns.

3. Rapid Adaptation: Active futures strategies can focus on shorter time horizons than traditional equity portfolios, allowing them to potentially make rapid changes given the right signal. While equity strategies keep an eye toward long-term growth, they generally are constructed by design to change positioning more slowly and must keep trading costs in check. As such, they may not be as equipped to react to the next sudden change in the investment landscape when it happens.

4. Liquidity Management: Futures are generally as liquid as equities – a key benefit for today’s pension plan administrators as many plans have increased exposure to more illiquid private markets compared to decades past.

Key Considerations

However, as with all investment decisions, the use of futures needs to be carefully considered in context of the specific plan. Factors such as the plan’s funding status, risk budgets, investment policy benchmarks, and fees can all impact whether and to what extent futures should be used in the portfolio – and how they’re best implemented. Plans may eschew what they perceive as a complex alternative because of poor experiences in the past, or unfamiliarity with evaluating managers in this space. However, there are solutions that mitigate many of these concerns while still providing for their improved outcomes to be realized.

Integrating Futures and Equities

While many may consider implementing futures as an overlay separate from their equity allocation, this has some drawbacks, including higher governance costs, worse capital efficiency, and higher fees.

Overlays require investors to perform their own risk management analysis, accounting for how the futures component will interact with their existing exposures. Further, they must evaluate an additional manager in a unique asset class, requiring multiple points of coverage, if they lack the expertise to actively trade futures based on trends and changing market conditions.

Overlays are also less capital efficient. In contrast, a modest position of futures within an equity strategy, such as a 5% cash allocation collateralizing a futures strategy, can make an outsized impact given the implied leverage offered by futures contracts – without changing the expected performance contours of an equity strategy.

The fusion of equities and futures comes with several advantages. It reduces the number of strategies, and therefore firms, to evaluate and monitor. It provides a turnkey solution that can be measured against a standard equity benchmark, potentially simplifying investment policy compliance and fitting within existing guidelines. Plans can also treat such a strategy like any other from a liquidity standpoint. Finally, an integrated equity and futures solution can adjust exposures against each component's positioning, which may improve beta management against equities in swiftly changing market conditions.

Conclusion

Traditional equity strategies face limitations in navigating time-varying risks associated with frequent market regime changes. Potential solutions – including futures, options, convertibles, and low volatility equity strategies – offer unique characteristics, such as active trading strategies, downside protection, equity participation, and reduced downside risk, which can complement traditional equity approaches.

These are each potential diversifiers to the relatively substantial risk source of long-only equities that can improve risk-adjusted returns; however, we believe integrating futures into a traditional equity portfolio offers the best combination of return opportunity, downside-protecting convexity, nimble adaptation, and equity-matching liquidity to fill this need for asset owners. This approach aligns with the evolving market dynamics and the need to navigate time-varying risks. And including futures within an equity portfolio simplifies implementation while preserving benefits to the investor.

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