S&P DJI: How do your clients think about risk, and how do their perspectives on risk inform your portfolio management approach?

Jerry: Our clients typically have the dual objective of growing their portfolio and preventing loss of capital. We approach asset allocation and portfolio management by first learning, through the financial planning process, our client’s long-term financial objectives, including risk tolerance. We then allocate accordingly. Once a portfolio is established, we manage it by monitoring it daily and rigorously rebalancing it back to the target asset allocations whenever actual portfolio asset allocations have drifted by more than the tolerances we have established. We also manage the cash balances in the portfolio to meet the client’s specific cash flow needs. Our overall goal is to achieve portfolio growth and to protect against loss of capital in the most cost-efficient way possible.

S&P DJI: In addition to trying to prevent loss of invested capital, what other benefits could arise from the employment of risk-managed portfolios?

Jerry: In our opinion, there are a number of qualitative and quantitative benefits of risk-managed investing (RMI), which we define as the attempt to go beyond traditional asset allocation to explicitly dampen volatility and/or limit downside potential. We believe that RMI permits investors to hold appropriate amounts of equities to combat inflation and meet their long-term financial objectives. A well-defined risk-management approach has the potential to help investors stay the course during periods of market turbulence and prevent them from making fear-based, self-destructive decisions (as many made in the wake of 2008/2009, depriving themselves of the wealth restoration that the equity market subsequently delivered).

S&P DJI: What are some of the benefits of the volatility dampening and downside protection aspects of RMI?

Jerry: The volatility-dampening aspect of RMI strives to add value by reducing risk drag, which we define as erosion of long-term compound returns due to short-term volatility of returns, and mitigating sequence risk, which represents the risk that a severe market downturn will precede a need to withdraw substantial portfolio funds. Sequence risk decreases with stability of returns. Volatility dampening can also help exploit tax effects, that is, in a tax regime with progressive tax rates [i.e., tax rates that increase with income], stable returns produce less tax liability than volatile returns, since, with volatile returns, the tax saved in down years is less than the additional tax accrued in up years. The downside protection aspect of RMI adds value by taking advantage of “return asymmetry,” the mathematical fact that every percentage decline requires a greater percentage gain to break even.
For example, a 25% decline from USD 100 to USD 75, requires a 33% gain (from USD 75 back to USD 100) to break even. This illustrates that avoiding a decline is the economic equivalent of capturing a gain of even greater magnitude. Through these means, RMI can benefit even the most aggressive, risk-tolerant investors over full market cycles.

S&P DJI: What are some of the potential costs of this approach?

Jerry: Risk management devices may have direct costs, such as the premium paid for a put option to protect a specific holding in the portfolio. There may also be opportunity costs, such as foregoing some upside potential, as can occur with an option collar (the simultaneous purchase of a put option and sale of a call option). More sophisticated RMI devices, including the use of volatility futures for example, can provide meaningful risk management with relatively little direct or opportunity cost.

S&P DJI: Is diversification of holdings across uncorrelated asset classes sufficient, in your opinion, for an investor to achieve the risk management they need?

Jerry: No. While the asset allocation process can help you construct an “optimal” set of portfolios from a risk/return perspective in most market environments, we believe asset allocation will not provide sufficient risk management in times of severe market stress. Generally, in such times, the correlations among all asset classes tend to rise closer to one, the asset classes themselves all decline at once, and diversification fails when you need it most to succeed. This is precisely what happened in 2008/2009. To provide more reliable risk management for clients, we have found that it is necessary to more explicitly address the downside risk of the riskier asset classes within the portfolio.

S&P DJI: What role do indices and index data play in your asset allocation and portfolio management processes?

Jerry: We use indices to represent each asset class throughout our asset allocation process, and use historical index data to help parameterize the probability distributions and copula functions. If a candidate asset class survives this process and to more explicitly address the downside risk of the riskier asset classes within the portfolio.

S&P DJI: What are some of the potential costs of this approach?

Jerry: Risk management devices may have direct costs, such as the premium paid for a put option to protect a specific holding in the portfolio. There may also be opportunity costs, such as foregoing some upside potential, as can occur with an option collar (the simultaneous purchase of a put option and sale of a call option). More sophisticated RMI devices, including the use of volatility futures for example, can provide meaningful risk management with relatively little direct or opportunity cost.

S&P DJI: Are risk-managed investments effectively benchmarked?

Jerry: No. Most RMIs tend to be benchmarked against the S&P 500®, which has no direct risk-management features beyond diversification and does not provide the investor context for determining whether the RMI under review is cost-effective. While the S&P 500 may represent a meaningful comparison over several complete market cycles (i.e., so one can observe whether the downside protection during down markets more than offsets the cost during up markets, over several full cycles), each of these cycles is of unpredictable length, and this makes comparing RMIs to non-risk-managed benchmarks problematic.

S&P DJI: How could benchmarks for risk-managed portfolios be improved?

Jerry: One way is to combine long exposure to the equity market with an exposure to a market hedge. An equity market hedge that most investors would easily understand is a long put option on the S&P 500. Having found no such combination benchmark, we approached S&P DJI and the Chicago Board Options Exchange (CBOE) to construct a custom index benchmark that would represent exposure to the S&P 500 with a simultaneous rolling monthly exposure to a 5% out-of-the-money put on the S&P 500. While this would not necessarily replicate the actual strategy within any single risk-managed equity investment, it would represent the objective of many similar strategies. We have been collaborating with S&P DJI and CBOE to create a benchmark that we think could be quite relevant to investors, given the proliferation of RMIs of various types over recent years. CBOE has also provided us with data from two existing indices they created: The CBOE S&P 500 95-110 Collar Index (CLL) and the CBOE VIX Tail Hedge Index (VXTH). We are currently analyzing the data from these three indices to see which would work best as a combination index for risk-managed investments that seek long exposure to the equity market and exposure to a market hedge. While past performance is no guarantee of future results, understanding how a strategy has performed in the past is a crucial step in the adoption of a new strategy.