INVESTMENT STRATEGIES IN A LOW CONVICTION ENVIRONMENT: FROM RISK MANAGEMENT TO NEW OPPORTUNITIES

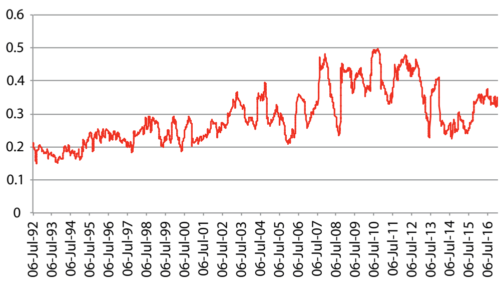
KEY POINTS

- The outlook for mainstream asset classes in 2017 is perhaps less clear than it has been for many years.
- Against this potential backdrop, investors are likely to be more open to diversifying into a range of yield-enhancing opportunities across asset classes.
- As there is no one-size-fits-all formula for successful portfolio management in this environment, investors need to assess their return objectives and risk tolerance levels before deciding on a hedging strategy.

Recent political events on either side of the Atlantic have intensified uncertainty among investors about the outlook for all mainstream asset classes. Dovetailing with the unwinding of accommodative global monetary policy, this has created an environment of low investor conviction.

A notable feature of market returns in recent months has been the accelerated erosion of these very high correlations between asset classes. Patrick Kondarjian, Head of Institutional and Wealth Management Solutions, EMEA, at HSBC's Client Solutions Group explains that this has been observable in rising rotations as well as in increased dispersion between sectors and in the returns of single stocks within sectors. It has also been suggested by the recent decline in the HSBC Risk-On Risk-Off (RORO) index. Created in 2010, this combines the rolling correlations of 34 assets encompassing commodities, equities, rates, FX and credit within a single index. An increase in the RORO index implies a rise in cross-asset correlations, while a decline suggests a weakening in correlation. The chart below shows the 'performance of the index' and incorporates simulated past performance of the index for the period July 1992 to July 2010 after which time actual performance is shown.

HSBC Risk-On Risk-Off (RORO) index



Source: HSBC, January 2017

The breakdown in correlations implied by the performance of the RORO index is a process which Kondarjian expects to gather momentum over the course of 2017.

OPPORTUNITIES IN DISPERSION TRADES

"In this environment, we observe that investors are receptive to some of the ideas we are exploring based on dispersion." Dispersion trading generally refers to the strategy of selling options on indices and simultaneously buying baskets of options on the individual components of those indices (or vice versa). Kondarjian explains that strategies of this kind have traditionally been popular with hedge funds, as a means of generating alpha by selling correlation and buying volatility.

"We are now seeing this strategy being adopted by other institutional investors" says Kondarjian. "They are implementing similar trades to hedge funds, but they are probably less driven by entry prices because they tend to use dispersion more as a macro play than as a way of expressing a view on the relative value of correlation or volatility."

One reason for the popularity of dispersion is the diversity of pay-offs available. "For example, clients unable to book complex trades based on multiple swaps on single stocks versus an index may prefer to trade bespoke packaged products in a securitised format."

FX: UNEXPLORED ALPHA FOR FIXED INCOME INVESTORS?

The shortage of conviction on the likely direction of mainstream asset classes is also leading investors to explore ways of minimising the risks associated with diversification, adds HSBC's Global Head of FX Overlay, Marc Tuehl. "One of the topics we have been discussing with clients is how they can use minimum variance hedge ratios, which rely on correlation and volatility of both the FX and underlying asset class" he says. "This can be an effective way of enhancing returns and reducing risks in portfolios exposed to two asset classes, such as underlying bond and currency risk."

HSBC has observed a discernible recent rise in demand from European life insurance companies for longer-duration US dollar assets ranging from real estate debt to private equity and longer-dated corporate bonds, all of which have interesting yield enhancement properties. This process, however, has exposed investors to an asset-liability mismatch, with liabilities typically denominated in euros or sterling and assets in US dollars.

"In equity markets, it is likely that there could be at least a partial offsetting of risk by the performance of the underlying equities. In fixed income markets, however, correlation levels have traditionally been relatively neutral," says Tuehl. "This is why portfolio optimisation based on flexible FX hedging is something that is becoming increasingly appealing to many of our clients. Generally, this is aimed primarily at mitigating currency risk. But investors are also becoming more aware of the opportunities that currency volatility can potentially generate in terms of unexplored alpha."

The impact of currency movements on the fixed income portfolios of sterling-based investors provides a striking and topical exemplar of the value of implementing more dynamic currency hedging strategies. "Taking the example of a UK-based investor, while sterling has depreciated versus the dollar over the last year, clients with a passive 100% hedge ratio have been largely disadvantaged in terms of potential returns compared to those who opted for a partial or dynamic hedging strategy," says Tuehl. This is in part because a passive hedging policy can expose investors to liquidity risk, with marks to market needing to be covered by cash as investors roll over their hedges.

Tuehl adds that there is no one-size-fits-all solution to currency risk management, and that the lens through which all hedging strategies need to be scrutinised is the risk tolerance level of each investor.

PREPARING FOR A RATES-UP SCENARIO: LESSONS FROM GERMANY

Another prominent variable likely to impact returns and market values of fixed income portfolios is the changing global monetary policies.

Marius Nolte, Co-Head of the HSBC Client Solutions Group for Germany and Austria, says that this is an especially sensitive issue for life insurance companies and pension funds in Germany, where fixed income allocations are still very high. As Nolte says, fixed income accounts for around 80% of the asset allocation of German insurers.

"When we ask clients whether they are considering implementing a rates-up hedging strategy, the consolidated feedback is that although they do not attach the highest probability to rising rates, they are definitely sensitive to the risk of this scenario," he explains. "Because they have such large reserves on long-term fixed income assets, German insurance companies and pension funds recognise that this is a crucial question from an economic as well as an asset liability management (ALM) and accounting perspective."

A decision to hedge the portfolio against the impact of higher rates must not compromise on the returns the accounts are contractually obliged to deliver to their policyholders or scheme members.

Duration alone is no longer enough. "The question facing investors is, what level of yield can they achieve by maintaining long duration exposure, and how can they manage the risks that accompany this in an environment of rising interest rates?" says Nolte.

HEDGING OR PORTFOLIO OPTIMISATION?

With respect to hedges against a potential rates up scenario Nolte says, "the vast majority of accounts would probably prefer to have an option-based strategy in place but is reluctant to pay a premium, which in the case of long-dated options can consume a substantial share of their annual portfolio return."

Against this backdrop, Nolte says that the strategy being adopted by German institutional investors is based not so much on hedging rather than on portfolio optimisation considering duration targets, yield enhancement and rates up risks.

"On the ALM side, for example, we're still seeing life insurance companies investing in long-maturity paper to meet the duration requirements of their liabilities," says Nolte.

Nolte adds that on the yield enhancement side "instead of investing in 30-year plain vanilla bonds, many German insurance companies tend to buy 30-year private placements from the same issuer in a callable format".

A strategy which is addressing yield enhancement purposes and which is more aligned with expectations of rising rates is to invest in shorter-dated loan products with a floating rate pay-off.

CONCLUSION: NO ONE-SIZE-FITS-ALL FORMULA

There is no off-the-shelf protection available, and each account will need to tailor its strategy based on its return objectives and risk tolerance, taking into account the regulatory and accounting idiosyncrasies of its country of residence.

The strength of the bank's balance sheet, twinned with a global network that encourages cross-fertilisation of investment ideas, make HSBC well-positioned to partner institutional investors through this uncertain period.

For more information, please visit
www.gbm.hsbc.com/dealing-room-of-tomorrow

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