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Black Swan Events and Capital Preservation Strategies

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“Current market turbulence and the benefits of dynamic protection strategies”

Given current financial market turbulence caused amongst others by US-China trades wars; Brexit; the US and in fact the state of the global economy; it is interesting to note that some market participants prefer not to engage in hedging or protection strategies to protect risky assets due to their perceived costs and/or complexities. The market has a diverse group of investors who have different risk and return profiles - that must be appreciated. It is therefore expected that some money managers will have return objectives very different from others. And in fact, stratifying the investor groups will describe a better view on who has an appetite for this current market volatility than others.

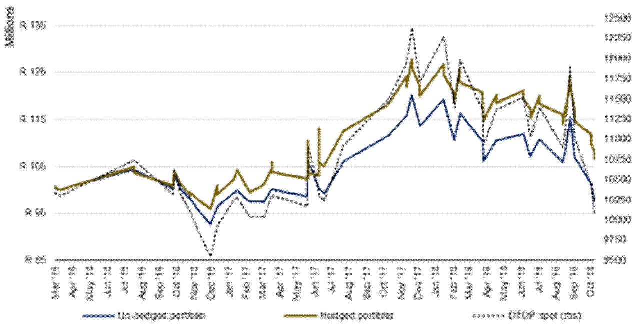
It is true that a long-term view in investments especially on some risky assets invariably pays off. It is equally true that some investors do not and need not have such volatile returns in their portfolios depending on where they are in their life stages. Research has shown that across all investor strata, reducing volatility of returns in members’ overall return profile contributes a lot in determining the optimal level of consumption and standard of living throughout one’s entire lifetime including after retirement.

Life staging models somewhat have similar objectives as managers who utilize hedging or protection strategies; that of reducing return volatility as members move closer to retirement. Fund Managers, including Mianzo Asset Management utilize as part of their investment process, dynamic protection strategies (see chart 1) to allow investors exposure to risky asset classes while seeking to provide an asymmetric return profile, or put differently, fall less when the market falls or “black swan” events occur, as seen in the recent past.

A Black Swan event, a term popularized by Nassim Taleb describing situations that are typically random and extremely difficult to predict. These are the managers that have to ensure that not only capital is preserved, but also that investors will not in critical periods realize negative returns on their benefit

These strategies also allow such investors close to retirement at times to significantly benefit from strong market growth. This obviously has to be compared with the opportunity cost of providing such protected market participation. Overtime, we observe that managers who are dynamic in their hedging programs reduce these costs tremendously, and sometimes allow members more upside participation when the market is trending upwards.

Chart 1: Hedged equity portfolio vs. un-hedged portfolio



Protection strategies however cannot be a one-size fits all. A proper segmentation and risk/return analysis of investor profile is critical to understand what assets classes to utilize to achieve a certain return profile without exposure to unwarranted risk. Core to our investment process is “capital preservation through explicit hedges, this also includes looking for investment opportunities that when identified and included in portfolios, fall less when the market falls, by having a decent margin of safety.

It is true that with the benefit of hindsight, managers would be more astute in determining the term and in most instances types of strategies to have in place, often looking at the term structure of volatility and the volatility skew which generally reflect market expectations on future implied volatility and the relationship between the implied volatility of at the money option and options far from current market levels, respectively. This information, intuitively gives a manager some kind of a view of when protection is cheap or expensive and which strategies to implement given certain market conditions. However, managers often workout probable returns on specific asset classes with a view of minimizing the probability of capping upside market participation. On the other hand, tail risks and those rare events, often unpredicted are much more difficult to work out.

At Mianzo, dynamic protection strategies are an integral part of our investment process and we believe in utilizing protection strategies that are easy to implement and manage, but equally effective in achieving the desired outcome to provide some level of certainty of investment returns.

Glacier Research would like to thank Luvo Tyandela for his contribution to this week's Funds on Friday.

Luvo Tyandela

Luvo is the founding member, Managing Director as well as a Portfolio Manager at Mianzo. Luvo started his career in structured products and derivatives in 2003. He was previously at ABVEST Associates in the Structured Products division, then he moved to Sanlam Investment Management (SIM) in the Absolute Return Division and also managed a Portable Alpha fund. Before he stablished Mianzo, he was at Clade Investment Management as CEO and Portfolio Manager. Luvo has extensive knowledge of derivatives instruments, fixed income (Bonds and Cash) and equity stock selection methodologies, and asset allocation.