THE ONLY CERTAINTY IS UNCERTAINTY

Proven Risk Management Strategies that Can Help

By Mitchell H. Caplan

For 2017, the true wildcard in the global markets has been geopolitics and accompanying political risk. In a recent survey released by Bank of America Merrill Lynch, more than 175 chief investment officers, asset managers, economists, and portfolio managers indicated that their top three concerns were trade war/protectionism (29 percent), U.S. policy error (24 percent), and a China yuan devaluation (15 percent).¹ Likewise, according to Jefferson National’s Advisor Authority study of more than 1,300 registered investment advisors, fee-based advisors, and individual investors nationwide, advisors rated global instability the second-most adverse factor impacting portfolios—and investors rated global instability the number-one portfolio concern.²

Many unknowns are dominating the market picture for 2017. Markets have been optimistic that Washington’s proposed combination of tax reform and reduced regulations will fuel the U.S. economy, but it is still unclear when these new policies will pass. Likewise, markets are apprehensive about a number of factors across the globe, including the outcome of Brexit negotiations, the rise of nationalism in the eurozone, relations with Moscow, tension in Southeast Asia, and sustained conflict in the Middle East. Concerns about political instability, combined with overvalued markets, on-again-off-again volatility, and record-low yields, create added complexity for advisors and their clients.

All these factors have a common denominator: uncertainty. But although uncertainty is high, optimism is also up—at least for investors who work with financial advisors.

According to the Advisor Authority study, investors who work with advisors are more optimistic (47 percent) than those who do not (35 percent). Clearly the increasing political and economic uncertainty, both domestically and globally, creates opportunities for expert financial advisors to add value—to ensure their clients’ futures and the futures of their practices.

Advisors must confront these evolving challenges and manage risk head-on. There are various solutions, with different degrees of return potential and complexity, to effectively manage the downside risk of portfolios and increase returns. A more traditional approach could include total return bond strategies or risk-managed allocations. A more innovative approach, discussed here, could include alternative strategies. In addition, using asset location to enhance the performance of liquid alternatives can help clients maximize accumulation and minimize year-end tax bills.

Managing Risk When the Efficient Frontier Shifts

Financial advisors are well-versed in the concept of the efficient frontier, which models the optimal balance of risk and reward for investors. Achieving the efficient frontier for clients is a driving force behind the investment choices that every advisor makes. Yet today’s market environment makes it increasingly difficult to manage this balance between downside risk and upside potential.

Traditionally, fixed income has been the fulcrum upon which advisors have helped...
clients manage risk as they transition from maximizing growth during the accumulation period to generating a stable income stream during retirement. But the current low-return expectation for bonds has caused a considerable shift in the efficient frontier, which has severely diminished the effectiveness of using fixed income to manage risk—especially for clients in the accumulation stage. The pressure is magnified by the fact that the U.S. Federal Reserve is in the process of slowly raising interest rates, which likely will drive returns even lower.

Figure 1 illustrates how returns for safe, low-risk bonds and cash have shifted downward, making the cost of safety significantly higher than it has been historically. This leaves clients with a difficult choice—should they accept a lower return or take on more risk?

This shift in the efficient frontier changes the expectations of how bonds will perform and how they should be used in a portfolio, leaving many clients with no choice but to accept more equity risk in their portfolios in order to meet long-term accumulation goals. This shift in portfolio allocation makes it more important for advisors to properly protect clients from downside risk.

The risk in equity markets remains, even in years of relative calm, because all markets, no matter the type, can be volatile and experience significant highs and lows. As shown in figure 2, the size of intra-year drops has been uncharacteristically small as recently as 2013 and 2014. But the start of 2016 was a healthy reminder that clients should be prepared for losses of 15 percent or more within any given year, even in a rising market. Even in a year with strong performance, such as 1998 or 2009, intra-year drops can be dramatic. Advisors should have a strategy in place to proactively manage tail risk, to protect portfolios from drawdowns, and to help clients avoid emotional responses to losses.

**Investment Solutions: Minimize Downside, Maximize Upside**

With the market continuing to pressure investors to accept lower returns or increased risk, managing client return expectations is an important balancing act. The first step is to work closely with clients to ensure they have realistic goals and expectations for risk and return. Whether your client is a conservative fixed income investor who can no longer achieve adequate returns but is hesitant to take on the added risk of equities, or an aggressive equities investor who wants to hedge against severe downturns and black swan events, advisors must have a strategy that can help them mitigate losses and ensure upside participation.

Alternatives can provide this strategy through a controlled range of exposure to the market in different scenarios. Alternatives also can provide a unique source of returns and risk that can significantly enhance diversification. Historically these types of alternative strategies, such as managed futures, hedged equity, and merger arbitrage, have been the exclusive domain of institutional and high-net-worth investors. But liquid alternatives, including 40 Act mutual funds, exchange-traded funds, and variable insurance trusts (VITs), offer many of the same characteristics of hedge funds and use the same nontraditional investing strategies, and also provide lower minimum investments, lower fees, and greater transparency. One most attractive quality of liquid alternatives is that they can be bought and sold daily, unlike traditional alternatives that may restrict clients to monthly or quarterly liquidity—or in some cases lock up assets for years.

**Assessing Liquid Alternatives Strategies**

Flexibility is the sweet spot of many alternative strategies. It is the reason why certain managers claim they are able to generate alpha. Advisors who have the experience necessary to identify sources of persistent alpha are well ahead of the game. But regardless of whether a manager can generate alpha, alternative strategies can be useful for enhancing diversification and managing risk with greater upside potential, as suggested by the following key categories of liquid alternative strategies:

**Long-short equity:** A strategy of taking long positions in stocks that are expected to appreciate and short positions in stocks that are expected to decline. It seeks to minimize market exposure, and profit from stock gains in the long positions and price declines in the short positions.

**Market neutral:** A strategy that seeks to profit from both increasing and decreasing prices in a single and/or numerous markets.
Market-neutral strategies often are attained by taking matching long and short positions in different stocks to increase the return from making good stock selections and decrease the return from broad market movements.

**Managed futures**: These are funds that use a trading strategy that relies on futures contracts to express views across a range of asset classes, such as equity, fixed income, commodities, and currencies. Many managed futures strategies utilize a trend-following approach.

**Multistrategy**: These funds use a combination of alternative strategies such as taking long and short positions in equity and debt, trading futures, or using convertible arbitrage, among others.

Liquid alternatives are now available in transparent ‘40 Act funds, and fully evaluating some alternative strategies requires expertise. Often the underlying strategies are as complex as those of illiquid hedge funds and detailed due diligence can be difficult. Liquid alternatives are not a magic asset class; the trade-off between return and risk still exists, but they are uniquely suited to manage very specific risks.

Advisors can take a targeted approach to identify alternative strategies that will meet specific needs within client portfolios. When selecting liquid alternatives, know the risks your clients are facing and focus on strategies with built-in structural reasons for providing the specific protection your client needs. The decision should not be based on a fund manager’s discretion, no matter how well the manager has done in the past. In addition, for the best results, ensure that the underlying securities owned by liquid alternatives can be liquidated quickly and without significant market impact.

**Analysis**

The following analysis looks at three different liquid alternative strategies that may be used to address three specific types of downside risk:

- Managed futures to hedge equity tail risk can provide outside return potential in periods of extreme equity market declines.
- Hedged equity to reduce risk near retirement can provide a defined limit or floor for downside risk so it does not fall below a specific level.
- Merger arbitrage to manage interest-rate risk can reduce volatility and diversify a specific risk in the portfolio.

The benefits of using these strategies are summarized in figure 3, and a closer analysis demonstrates how they can be used to manage specific risks. These particular strategies sometimes are viewed as alternative beta products. As with any beta product, the selection process should focus on cost, efficiency, and execution.

**Managed Futures to Hedge Tail Risk**

Tail-risk events are rare, but during times of crisis or financial market distress, the magnitude of losses suffered by all asset classes at the same time can decimate a portfolio. Managed futures historically have provided a powerful level of portfolio protection in crisis markets without significant negative impact on returns in normal markets, as shown in figure 4. Since 2000, managed futures have offered similar or greater diversification benefits and tail-risk protection compared to high-quality bonds, and they have generated annual returns averaging roughly 6 percent. The outlook for protection and upside potential is unlikely to change.

Most managed futures funds are trend-following, which is what produces the tail-risk hedge. These trend-following managed futures strategies invest in various stocks, bonds, and commodities as price trends develop over time, buying long in markets that are trending higher and selling short in markets that are trending lower. The downside protection offered by these trend-following managed futures strategies is driven by the same flight-to-quality phenomenon as high-quality bonds. The rationale for using trend-following managed futures as a tail-risk hedge includes the following:

- Very sharp stock market losses have never happened in isolation. They impact other financial markets and persist for some time.
- The systematic approach of following price trends, instead of focusing on fundamental values, positions this strategy favorably during times of a liquidity crisis.
- Since coming to market, high-quality trend-following managed futures mutual funds and VITs have met performance expectations when compared to their hedge fund counterparts.

**Hedged Equity to Reduce Risk near Retirement**

Avoiding losses is important as clients approach retirement. But most clients need greater growth potential at this time to meet their goals. A long-short equity

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**Figure 3: Outlook—Alternative Strategies Considered**

<table>
<thead>
<tr>
<th>INVESTMENT OBJECTIVE</th>
<th>MANAGED FUTURES</th>
<th>HEDGED EQUITY</th>
<th>MERGER ARBITRAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Predictable Income</td>
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<td>●●●</td>
<td>●●●</td>
</tr>
<tr>
<td>Stable Principal</td>
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<td>●●●</td>
<td>●●●</td>
</tr>
<tr>
<td>Source of Return</td>
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<td>●●●</td>
</tr>
<tr>
<td>Diversification</td>
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<td>●●●</td>
<td>●●●</td>
</tr>
<tr>
<td>Tail Risk</td>
<td>●●●</td>
<td>●●●</td>
<td>●●●</td>
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</table>

strategy with a defined downside hedge in place, typically called a hedged equity strategy, can provide more dependable downside protection than bonds. To be effective, it is critical that these downside hedges are applied systematically and are not subject to a manager’s discretion.

A hedged equity strategy can eliminate the risk of sharp losses from stocks and also capture most of the upside in normal markets, as shown in figure 5. S&P performance from 2001–2016 is grouped by decile to compare the performance of two different indexes that use systematic hedging strategies and different time horizons. The Chicago Board Options Exchange (CBOE) index is designed to cap monthly losses at 5 percent, and the Exceed Defined Protection Index (EXPROT) seeks to capture market exposure within a defined range, with gains of no more than 15 percent and losses of no more than 12.5 percent in any given year.

During typical up markets, shown in decile 3 through decile 8, both CBOE and EXPROT are roughly in step with the S&P.
in most cases within a few percentage points. In the most extreme downturns, when S&P losses average –29.9 percent, both hedged equity strategies offer clear protection, with CBOE losses averaging –19.6 percent and EXPROT losses averaging –5.6 percent. It is only in the most extreme upswings that both hedged equity strategies lag, when S&P gains average 33.9 percent, CBOE gains average 21.9 percent, and EXPROT gains average just 15.9 percent.

Merger Arbitrage to Manage Interest-Rate Risk
It is common for advisors to add floating-rate loans to traditional bond portfolios to ease this duration risk. Loans can limit interest-rate sensitivity, but they do not diversify the liquidity and credit risk common in most diversified bond portfolios. As shown in table 1, merger arbitrage is an alternative strategy that can offer a return similar to loans, with much lower volatility and substantially lower drawdowns.

An arbitrage strategy is one of the most likely to come to mind when describing hedge fund investing. It is designed to profit from mispricing in the market by investing, long and short, in two similar assets that are trading at different prices. Going long on the cheaper asset and going short on the more expensive one will minimize the market risk in the portfolio.

Merger arbitrage focuses on the mispricing between target companies and their acquirers and also hedges against overall market risk. Merger arbitrage has become such a widely applied strategy that systematic indexes are available at reasonable costs, and many liquid alternatives using this strategy are available. Some active managers may add value, but a low-cost, broadly diversified merger arbitrage fund will provide the return profile necessary for most clients.

Using Asset Location to Enhance Alternative Strategy Performance
Utilizing alternatives to control downside risk is a practice advisors can borrow from institutional investors, who often have specialized expertise in evaluating these strategies—and who typically benefit from tax-exempt status. However, some advisors avoid alternatives because of their high tax-costs. Whether these alternative strategies generate short-term gains due to frequent trading, or generate ordinary income due to the types of assets used, the results are the same—higher client tax bills. But just as liquid alternatives are a solution to boost the performance of a client’s portfolio, asset location is a solution to further enhance the performance of these tax-inefficient liquid alternatives.

Asset location is the strategy of holistically reevaluating a client’s holdings across all accounts and locating the most tax-efficient assets in tax-deferred vehicles. To maximize benefits, begin with the optimal investment mix to meet a client’s objectives and risk profile. Based on the tax-efficiency of assets in the portfolio and the client’s liquidity needs, first max out qualified plans, then use vehicles such as low-cost investment-only variable annuities (IOVAs). In this way, asset location can expand the universe of potential investments including high-quality alternative strategies that may not have been considered due to their tax implications.

The following analysis, as illustrated in figure 6, demonstrates the benefits of replacing fixed income with liquid alternatives and shows how proper asset location can minimize the impact of taxes when using these liquid alternative strategies. It assumes a client in the highest tax bracket, with a $1-million starting balance, including a $250,000 individual retirement account (IRA) and a low-cost, no-load IVOA for locating additional tax-inefficient assets. It begins with a traditional 60/40 model that includes equities, bonds, master limited partnerships (MLPs), and real estate investment trusts (REITs), which is compared to an alternative model that includes equities and liquid alternatives such as managed futures, hedged equity, and merger arbitrage.

By replacing the majority of fixed income with liquid alternatives, and then maximizing asset location by using an IVOA, the expected liquidation value of the total portfolio in 20 years increases from $3.3 million, with after tax-returns of 6.0 percent in the traditional 60/40 model, to $3.8 million with after-tax returns of 6.7 percent in the alternative model (see figure 6).

Note that liquid alternatives hold a variety of nontraditional investments and often employ more-complex trading strategies that can react differently to political, market, and economic developments than the market as a whole. To use liquid alternatives prudently, investors need to be aware of the risks involved with techniques such as short selling, leverage, and derivatives. Before discussing alternatives, reconfirm client goals, time horizon, and risk tolerance. This is fundamental when considering whether alternatives are right for clients.

Conclusion
Today’s challenging environment of political instability at home and abroad, combined with overvalued markets, on-again-off-again volatility, and record-low yields, has spurred a growing number of investors to turn to advisors for holistic and unbiased guidance. All this is happening at a time when clients also face the difficult choice of accepting lower returns or taking on more risk, so new solutions to manage the downside and preserve the upside are increasingly important.

Bonds will remain a critical component for generating retirement income, but alternative strategies are useful substitutes during the accumulation period for managing risk and generating greater returns. Alternatives are no longer the domain of institutional and high-net-worth investors. Today many liquid alternatives are available as ‘40 Act funds that can help to mitigate specific risks as they capture more upside potential.

There are differences in the types of alternative products available, and expertise is needed to evaluate many of these complex and esoteric strategies. We examined three basic alternative strategies, including managed futures to hedge tail risk, hedged equity to reduce risk near retirement, and merger arbitrage to manage interest-rate risk.
One of the biggest impediments to using these liquid alternatives is their tax implications. Just as using liquid alternatives can boost the performance of a client’s portfolio, using asset location can further enhance the performance of these liquid alternatives and maximize returns. In these challenging markets, when the only certainty is uncertainty, liquid alternatives combined with asset location can help advisors add greater value for clients and increase assets under management.

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Endnotes

Important Disclosures:
Variable annuities are investments subject to market fluctuation and risk, including possible loss of principal. Your units, when you make a withdrawal or surrender, may be worth more or less than your original investment.
Variable annuities are long-term investments to help you meet retirement and other long-range goals. Withdrawals of tax-deferred accumulations are subject to ordinary income tax. Withdrawals made prior to age 59½ may incur a 10% IRS tax penalty. Jefferson National does not offer tax advice. Annuities and IRA tax-deferred accumulations are subject to ordinary income tax. Meet retirement and other long-range goals. Withdrawals of tax-deferred accumulations are subject to ordinary income tax. Annuities and IRA tax-deferred accumulations are subject to ordinary income tax.
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Jefferson National does not offer tax advice.
Annuities are not deposits or obligations of, or guaranteed by any bank, nor are they FDIC insured.

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Figure 6: Enhance Liquid Alternatives with Asset Location—Additional After-Tax Accumulation over 20 Years ($1-million Starting Balance)

Traditional 60/40 Model with Asset Location after 20 years: 50-year-old client with $530,000 in a taxable account, $250,000 in an IRA, and $220,000 in a low-cost IOVA, investing for 20 years

Alternative Model with Asset Location after 20 years: 50-year-old client with $450,000 in a taxable account, $250,000 in an IRA, and $300,000 in a low-cost IOVA, investing for 20 years

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Expected Returns Used in Simulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>Large cap 9.0% Long-term bonds 4.3% U.S. REIT 6.3%</td>
</tr>
<tr>
<td>Age: 50</td>
<td>Mid cap 9.4% High yield bonds 4.4% MLP 10.4%</td>
</tr>
<tr>
<td>Retirement age: 70</td>
<td>Developed int’l 7.5% EM bonds 2.5% Managed futures 6.3%</td>
</tr>
<tr>
<td>Tax Rate (35% Federal, 5.41% State)</td>
<td>EM equity 9.7% Loans 4.0% Merger arbitrage 3.0%</td>
</tr>
<tr>
<td>Tax Rate at 70 (28% Federal, 5.41% State)</td>
<td>Muni bonds 1.8% Foreign bonds 2.8% Hedged equity 6.0%</td>
</tr>
</tbody>
</table>

Source: MPI Stylus. Estimates are output of a Monte Carlo Simulation using historical covariances of each asset class (March 2002–June 2016) and expected future returns. 30,000 20-year scenarios were run using a Downside LogStable distribution assumption. Expected Return and Volatility represent the average of the sample. Tail risk represents the bottom 1 percent of all annual forecasts. Years Underwater Risk represents the bottom 5 percent of longest period of cumulative negative return in the forecasts.