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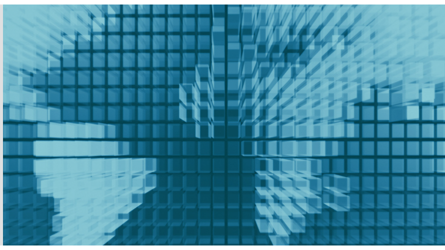

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# Low vol equity: there's another way

## "Put-write" strategies have nearly kept pace with equities, but with fewer drawdowns


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**Key Takeaways:**

- For investors who want to participate in stock market returns without taking the accompanying risks, a disciplined, secured put-writing strategy can potentially fit the bill
- An active put-write approach can keep risks and opportunities relative to the market in balance by actively managing the options as the strategy's market exposure changes, rather than simply waiting until the options expire
- Put-write helps investors avoid extreme tails, giving up some return during rising markets in order to avoid the full impact of market crashes.

Equities have proven their worth over the decades, returning huge multiples to investors willing and able to stay in the market for the long term. Wars and depressions have come and gone, and still equities have tracked upwards.

For the few – high net worth investors and some endowments – staying fully invested for the duration is possible. For the rest, particularly most institutional investors with liabilities to meet, volatility and market crashes are not acceptable risks. But how to mitigate them?

### The challenge of removing risk

Removing risk while maintaining meaningful exposure to equities is no simple task. Many have tried.

Existing low-volatility equity strategies include dividend-paying stock funds, but the downside protection offered by the "yield cushion" on these funds can be small. Then there is low-volatility indexing, but this depends on the historically low standard deviation on individual stocks remaining low. Some investors have turned to merger and convertible arbitrage strategies, but these generally only bear fruit at certain points in the market cycle and tend to have limited capacity.

So is there a strategy which can both participate in the long-term return potential of equity markets and also deliver reliable and meaningful reduction in risk? There is, and it is known as a "put-write" strategy.

### All about put-write

Put-write is not perhaps the most catchy of names, but it encapsulates the strategy succinctly.

At the heart of Gateway Investment Advisers' put-write strategy is the belief that in the long run, equity markets are the most reliable source of investment returns. So Gateway, an affiliate of Natixis Investment

Managers, has built an investment strategy which is designed to be highly correlated to stock indices, while consistently removing a significant portion of the volatility and downside risk associated with equity markets.

In the first part of the investment process, Gateway's investment management team writes a put option on a stock index and receives cash up front for selling it. In fact, the team writes a great many options, receiving cash which is then added to a portfolio of investments such as cash or short-maturity government bonds, that cover, or secure, potential losses on written put options. So, unlike most equity strategies, the put-write strategy has immediate income. This acts as a cushion against downward movements in the stock index.

**THE EXPLAINER: PUT OPTIONS**

A put option is a contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying security or index at a specified price within a specified time.
A put option's price generally moves opposite of the price of the underlying security or index—increasing as the price of the underlying asset falls and decreasing as the price of the underlying asset rises.
Key features of listed index options:

- Liquid
- Transparent
- Trade on exchange, so no counterparty risk
- Reliable correlation to stock indices

Once the put options are written, there are benefits and risks to consider regardless of which direction the index moves.

- If the index rises in value, the benefit is a positive return— the cash received up front is 'earned' as the value of the written put option declines. The risk of a rising market scenario is that the cash received up front is less than the amount the underlying index increases. In this scenario, the put writing strategy earns a positive return, but it may be only a portion of the return of the underlying index. If the index falls in value, the benefit of the written put is downside protection, while the risk is the potential for a negative return.
- If the decline in the index is greater than the amount of cash received up front, the put writing strategy may have a loss, but it will be a smaller loss than the loss of the underlying index. If the loss of the underlying index is smaller than the cash received up front for writing the put option, the strategy could have a slight gain, while the underlying index has a negative return.

The end result is a strategy that can participate in the positive returns that equity markets frequently generate, but experiences less volatility and delivers reliable downside protection during market declines. The strategy delivers these benefits without requiring the manager to correctly anticipate market direction or pick the 'right' stocks.

### Why does it work?

In general, investment strategies aim to enhance returns by buying an asset which is underpriced and selling it at a higher price. Put-write is little different.

By writing put options, Gateway is effectively selling an overpriced asset. Why is it overpriced? Because the asset in this case is implied volatility (forward-looking volatility that is priced into the index options markets) and investors tend to pay too much to insure themselves against volatility.

Therefore the strategy works by collecting a volatility premium. We know that the volatility premium exists because realised volatility – which is a backward-looking measure of actual price changes in an index – tends to be lower than implied volatility, which is the future volatility expected by the market. From January 1990 to March 2018, implied volatility for U.S. equities, for instance, was overpriced approximately 90% of the time (on a monthly basis).

Participants in a market generally over-estimate volatility because they don't know which direction a market is headed in the coming weeks and months, and this creates fear. People are willing to pay to help them face their fears, that is they are willing to buy insurance that protects them in the event the outcomes they fear actually come to pass.

In this sense, writing index put options is very much like writing insurance for better known risks, such as illness and vehicle accidents.

### Equity-like returns, without the tails

Many investors are unfamiliar with put-write strategies and want to know how they might perform under different market scenarios.

Investors tend to be attracted, in particular, by the strategy's potential to outperform stock indices during market downturns. Put-write helps investors avoid extreme tails, giving up some return during rising markets in order to avoid the full impact of market crashes.

The benchmark index for put-write strategies, has had a lower drawdown than a U.S. Large Cap Equity Index every year since its inception in 1986 through 2017. The average maximum drawdown a year was 9.3% for the benchmark index for U.S. put-write strategies compared with 13.7% for the U.S. equities[1].

So, in down markets, the strategy wins by losing less. If investors can avoid the large short-term losses associated with long-term equity exposure, they can recover portfolio losses in short order and get back to compounding returns much sooner.

Meanwhile, in positive markets, the strategy also delivers. Consistently selling the over-priced asset – volatility – creates the potential for better risk-adjusted returns than the equity index. From June 1986 to December 2017, the U.S. put-write strategies returned an average of 10.07% a year. This compares with the average return from the U.S. equities of 10.26%. It can be seen that the performance is almost the same, except that the put-write strategies returns were generated with only 75% of the volatility (standard deviation)[1].

### Puts in the portfolio

Investors are sometimes unclear how an options-based strategy, which may be very different from any other strategy they have previously encountered, fits with their existing portfolio holdings. There are a number of possibilities, but the main two are: as part of the core equities allocation; and as an income-producing alternative to low-yielding bonds.

Given the high correlation of the strategy to equity markets, there is a clear fit with the equities portfolio. It is a strong contender for the core element of an equities allocation due to its low volatility, which typically removes between and a third and a half of equity market risk.

At the same time, many investors seek alternatives to low-yielding bonds, and may consider strategies such as high-dividend equities. But these strategies can come with high drawdown risks which increase the overall risk of the portfolio, relative to fixed income. The put-write strategy offers income-generation that allows for consistent participation in market advances while potentially mitigating market declines.

### Getting active

Not all put-write strategies are created equal. Considerable portfolio management skill and trading discipline is required to reduce volatility and produce genuine alpha.
This is in contrast to a put-write index, which is rules-based and holds options to maturity, whatever the market environment. Although the time to maturity may only be a few weeks, markets can move fast in the interim, changing the value of the option and therefore the risk profile of the put writing index.

- If the U.S. equity Index falls significantly shortly after the put-write index writes its option, its risk profile increases as there may be little left to protect the option writing strategy from additional market downside from that point until it is replaced.

- Conversely, if the U.S. equity rises significantly in between expiration dates, its risk profile decreases and the put-write index may have very little market exposure and very low participation in additional market upside for a time. Once the put-write index put option expires, it writes a new one and the cash received 'reloads' its return potential if the market advances and its protection potential if the market declines.

An active approach, such as the one taken by Gateway, can keep risks and opportunities relative to the market in balance by actively managing the options as the strategy's market exposure changes, rather than simply waiting until the options expire. Gateway's investment team strives to ensure that investors are not overly exposed if the market goes into a freefall and also to ensure they participate more fully if the market rallies, potentially capturing more of the upside than a rules-based index.

The skill to do this is not intrinsic at most fund firms. For Gateway, however, options strategies are its one focus - a four-decade obsession, rather than a bolt-on strategy designed to complement a wider range of funds. Gateway's portfolio managers, who have an average of 18 years with the firm, do not have to contend with the distractions of, say, having to manage a fixed income or CTA strategy in tandem.

Long experience has taught the managers that complexity is not necessary or desirable in a put-write fund. The Gateway strategy is relatively "plain vanilla" in that it seeks primarily to manage and reduce equity risk using liquid options, which are listed on exchanges and priced transparently. Gateway's investment team takes a measured approach in the implementation of the strategy, maintaining a diversified portfolio of written options and making adjustments on an incremental basis to make the success of the strategy less dependent upon the timing of its trades.

### Conclusion

For investors who want to participate in stock market returns while mitigating the accompanying risks, a disciplined, secured put-writing strategy can potentially fit the bill. Relative to stock markets, the strategy has the potential benefits of high correlation, but also lower standard deviation and smaller drawdowns, leading to positive returns on a more consistent basis.

Written on 9 April 2018

1. Source: Gateway Investment Advisers, LLC. Figures mentioned refer to previous years. Past performance does not guarantee future results.
Performance characteristics of the Index representative of put-write strategies are not reflective of Gateway's put-write strategy performance.

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