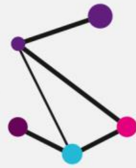


Advertising communication

Overlay

Written in February 2022
by Simon Aninat, Volatility & Overlay Manager

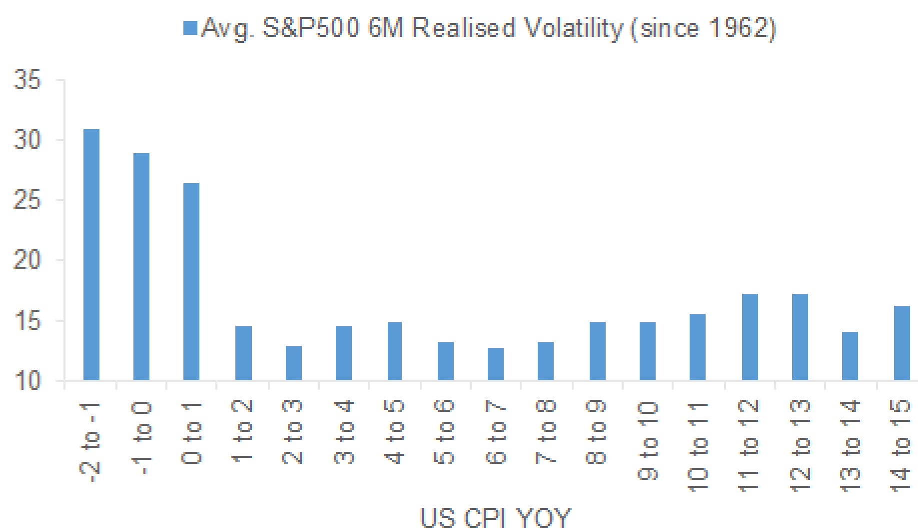
"Inflation & how to hedge portfolios"

In these early days of 2022, everybody is talking about inflation. Many financial operators believe that higher inflation could lead to more volatile equity markets. In our view, the link between inflation and volatility is more complex than it seems. The reasons why are set out below.

Let's start by looking at the link between inflation and the volatility of risky assets, and also at the impact of inflation on diversification within an allocation and how portfolios should be hedged.

Inflation – volatility: A cause and effect relationship?

If we compare US inflation data against the volatility of returns on the S&P500 since the 60s, there is no proof that the actual volatility of the S&P500 was greater when inflation was high. It even appears from the historical data that volatility is structurally higher during deflationary periods, which are often associated with periods of recession.



Source: Seeyond, Bloomberg, 31/12/2021. The figures stated refer to historical data. Past performances are not a reliable indicator of future results.

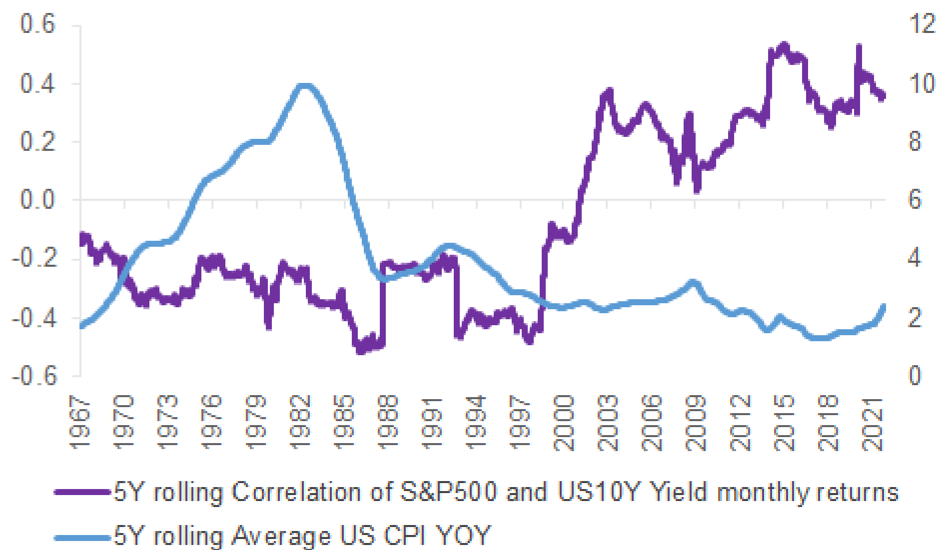
The relationship between inflation and volatility is therefore not just determined by the rate of inflation.

In the minds of most investors, higher inflation nevertheless means an increase in equity risk. We have seen that it is unlikely that stock market index volatility will increase much if inflation continues to rise, but this belief has a logical foundation.

Who remembers the "good old days" of the 60s and 70s?

During the last three decades, we have become used to government bonds being negatively correlated with equities, which provided a natural hedge in 60/40 allocations.

This wasn't the case prior to the 90s though. If we look at the correlation between the S&P500 and US 10-year bond yields since the 60s, we see that, when inflation has been high, the correlation has tended to be negative, which means that government bond prices have tended to fall alongside share prices. In a traditional allocation, this means that government bonds and the equity markets may experience the same trends. Natural diversification therefore disappears, making the portfolios of diversified investors very volatile as a result.



Source: Seeyond, Bloomberg, 31/12/2021. The figures stated refer to historical data. Past performances are not a reliable indicator of future results.

More recently, with the rise in inflation, this correlation has begun to change, prompting fears that we might return to conditions similar to the 60s and 70s, where inflation was climbing and equities and government bonds were positively correlated, leading to a higher volatility into investors' portfolios.

Hedging portfolios against volatility: an overlay management strategy

<u>Key risks</u>: the risk of capital loss, volatility risk, equity market risk and model risk

Investors who are concerned about their portfolios' risk increasing may opt for an overlay management strategy to reduce their risk. If government bonds no longer reliably hedge equities, an explicit equity hedge must be considered, which may mean using a protection overlay solution. This solution allows investors to keep their current investments while reducing the risk of their allocation's volatility increasing.

As the chart and table below show, Seeyond overlay strategy was able to reduce drawdown and volatility and to improve the Sharpe ratio in relation to the benchmark:

	Seeyond Fund		MSCI Europe NR	
	2020	2021	2020	2021
Performance (net of fees)	1.6%	18.52%	-3.3%	25.1%
Sharpe	0.1	2.6	-0.1	2.0
Volatility	16.3%	7.2%	28.2%	12.4%
Max Drawdown	-22.5%		-35.3%	

Source: Seeyond, Bloomberg, 31/12/2021. The figures stated refer to historical data. Past performances are not a reliable indicator of future results.

A reproducible and customisable process

<u>Key risks</u>: the risk of capital loss, volatility risk, equity market risk and model risk

Seeyond's overlay strategy mainly consists in buying put options at a low cost when volatility is low, then reselling them when volatility is close to its peak, which is usually just after a severe market correction.

The concept of buying and selling options under market conditions is simple enough to understand, but not always simple to apply. It requires an approach based on rules that are both rigorous and reproducible, and specific volatility management expertise. As an equity risk manager, Seeyond has in-depth knowledge and know-how in the quantitative and derivative management field, and has set itself an objective of reducing risk within our portfolios. "When it comes to our overlay strategy, we only use options listed on regulated markets, which means that we can be a lot more responsive and dynamic than if we were using OTC/Structured solutions that are more difficult and costly to make changes to if needed," says Emmanuel Bourdeix, Chief Executive Officer of Seeyond.

Specific expertise is also necessary to customise each client's overlay portfolio. Seeyond has €1 billion of assets managed using overlay strategies on behalf of institutional clients. "We have been assisting our clients with these overlay solutions since 2014, and through our discussions with them we understand their needs and expectations increasingly well," explains Simon Aninat, Volatility and Overlay Strategy Manager at Seeyond.

Overlays can be adapted to any investment universe, if appropriate liquid options are available. This means that exposure to all the US and European indices, and many Asian indices, can be hedged. An index may also be put together using a basket of options, which is correlated in an optimum way with the equity portfolio of a retail client. As well as customising the universe to be hedged, we try to meet our clients' needs as closely as possible in terms of reducing factors such as drawdown and volatility.

Conclusion – Mitigating risk and generating alpha

Volatility is both a risk that must be taken into account and an opportunity to generate alpha. In the current environment, there are many reasons to consider an equity protection overlay, including the unstable correlation between equities and government bonds, the announced withdrawal of liquidity by most central banks after years of massive injections, the increasingly erratic behaviour of retail investors in the US, and many others.

A rigorous overlay strategy may help investors to reduce the impact of strong market corrections and achieve their long-term growth objectives.

About Seeyond

Seeyond is Natixis Investment Managers' active quantitative management specialist. Through an approach that introduces an active human aspect to the rigour of quantitative investment processes, Seeyond offers strategies whose aim is to generate an optimum return on risk, in three areas of expertise: equity management, multi-asset class management and volatility & overlay management. The management teams rely on proprietary quantitative research.
Seeyond has a staff of 26 recognised asset management specialists with financial market experience of 18 years on average, and manages 8.8 milliards d'euros of assets[1]. Seeyond's products are marketed by the global distribution platform operated by Natixis Investment Managers, one of the world's largest asset managers[2], and by the networks within the BPCE Group, France's second largest banking group[3].

> Find out more at www.seeyond-am.com

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1 Source: Seeyond at 30/06/2021
2 Cerulli Quantitative Update : Global Markets 2021 a classé Natixis Investment Managers 15e plus grande société de gestion au monde, sur la base des actifs sous gestion au 31 Décembre 2020.
3 Source : BPCE S.A. – 31/12/2020

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