EDMOND DE ROTHSCHILD

L'AGEFI

CAPTURING EUROPEAN EQUITY UPSIDE WHILE LIMITING SEVERE SHOCKS

After an excellent 2017 on markets, equities are no longer looking particularly attractive. And yet, they are still an essential performance driver. As a result, institutional investors are now moving towards equity risk hedging strategies, a solution which combines structural and cyclical advantages.

Investors have been forced to adapt to a world where assets are expensive. That is certainly the case for equities, even if Europe appears to have some catch-up potential vs. the US. And other asset classes are even dearer, starting with government bonds.

Holding equities is harder for institutional investors subject to Solvency 2, especially as the Solvency Capital Requirement (SCR) has risen as markets advanced. And volatility, after peaking in February, looks set to stay high, a development which has triggered fresh fears of a significant market fall. And yet, there is a real need to include performance drivers in a portfolio and equities do this much better than other asset classes. Faced with such a complicated environment, one solution is for investors to fine-tune equity market exposure with strategies focused on mid cap stocks, particular geographical zones or even unlisted assets. There are also long/short (1) equity strategies, convertible bond strategies which seek to add convexity to equity exposure, or others which hedge equity exposure to protect against downside risk. ▸

Thomas Guyot, technical and financial director at Suravenir.

MOST OF SURAVENIR'S EQUITY ALLOCATION WILL END UP BEING HEDGED

Survanir is Crédit Mutuel Arkéa's life assurance and provident affiliate. We have €40bn under management in life assurance products and took in more than €4bn in new money last year. That meant a lot of money to invest, even if we are focusing more and more on unit-linked solutions", says Thomas Guyot, technical and financial director at Suravenir. The group's allocation is diversified but equity exposure is still a low 7-8% of total assets and more like 4-5% excluding structured products. Thomas Guyot adds, "Our life assurance business suffers from being somewhat asymmetrical as the gains are paid to our clients while losses, or at least the biggest losses, have a negative impact on the group's equity." Hence the use of hedging which will in time be extended to the entire equity allocation, apart from geographical exposures where there are no satisfactory hedging possibilities.

Suravenir, has long been thinking about a strategy to deal with life assurance company liability constraints (see box). "*We looked hard but failed to find a satisfactory way of protecting our equity sleeve*" says Thomas Guyot, finance and technical director at Suravenir. "*In fact, the arrival of Solvency 2 acted as a trigger because equity exposure became too capital-consuming. Systematic hedging of equity exposure met our need to reduce volatility and SCR. The interest rate factor also helped: it was complicated to do without equities and the yield break-even point for a hedged strategy compared to a bond investment was low.*" Regulatory shifts also triggered the PRO BTP Group's decision to go for the same strategy two years ago and it is no coincidence that Edmond de Rothschild Asset Management's solution, the EdR Equity Europe Solve[2] fund, was launched the year before. "*The situation forced us to scrutinise the biggest risks as investors had new expectations for managing maximum drawdown and reducing volatility. Insurance companies are also very keen to avoid provisioning. Our permanent total/partial hedging strategy helps us avoid running the risk of emergency action when provisioning trigger points loom,*" says Michaël Nizard who runs the fund.

> “ Hedging's structural appeal can be reinforced by developments like the return of volatility ”

Hedging's structural appeal has been reinforced by developments like the return of volatility or equity capital cost changes. "*Between January 2016 and today, the cost increased as markets rose, and equity SCR has risen from 35% to 40% recently*[3]" adds Michaël Nizard.

But sometimes institutionals can meet some resistance over adopting hedged equity solutions. Frédéric Sadaca, head of overlay management at the PRO BTP group says, "*Our group is collectively managed, and we had to convince our board directors who had difficulty understanding why we should hedge holdings that had been bought precisely because they were supposed to represent better long-term returns.*" Naturally, arguments over hedging mainly revolve around an insurance group's liability constraints (see box "Three reasons to hedge") but not only. "*Even without current liabilities, this sort of solution offers a performance lock-in.*[4] *Take, for example, a highly volatile index with a 100 base which returns 100% in the first year and then drops 50% in the second. Any direct investment would have ended back where it started at 100 whereas with a hedge costing 5% a year it would be at 170 after 2 years.*"

Latent capital gains are another possible obstacle. We had built up quite a few and as we didn't want to hedge the balance sheet directly, we had to realise them", says Thomas Guyot. "*Hardly an ideal accounting solution but you can't have your cake and eat it.*" Each institutional has its own method: Survenir opted for a fund but the PRO-BTP group decided on direct protection of its balance sheet. Equites have been on an uptrend in the last two years but Frédéric Sadaca still thinks the decision to test hedging was successful and the percentage of hedged equity strategies at PROP BTP is set to increase.

And, Thomas Guyot adds, "*Even if Solvency II were to disappear, we would no doubt keep our hedges as they are part of a sound investment approach*".

Before hedging an equity portfolio, it is crucial to estimate if the cost

(1) A strategy which goes long on stocks considered undervalued and short on those deemed overvalued.
(2) Fund launch date 07/12/2015
(3) Source: EIOPA (European insurance and occupational pensions authority) at end February 2018.
(4) A rachet, or performance lock-in, serves to secure the previous year's returns.
(5) The fund's benchmark has been the composite index of 56 % MSCI Europe (NR) + 44 % capitalised EONIA (EUR) since 14/12/2016. Previously, the benchmark was the MSCI Europe (NR) (EUR).

Michaël Nizard, manager of the Edmond de Rothschild Equity Europe Solve fund

> “Before hedging an equity portfolio, it is crucial to estimate if the cost is bearable”

is bearable. Volatility has been overlooked in recent years, but Michael Nizard's simulation takes it into account and the result is instructive. “*Since June 30 2005, the Eurostoxx 50 NR has gained 156%* [5].

But if we had managed to reduce the 3 largest down phases [6] by 40%, returns would have hit 300% at end February 2018. This deviation is key as it shows that looking to limit involvement in major market shocks can create value. There is a case for optional portfolio insurance as it reduces the impact of jolts while offering the chance of achieving returns close to those of the market.”

Hedging philosophy is also conditioned by portfolio hedging costs. “*Of course, there are relatively passive hedges based on holding options till they expire but in our Solve strategy we have opted for discretionary and dynamic hedging*”, says Michaël Nizard.

This approach helps limit hedging costs while adapting to changing market conditions. For example, a market at the top of the economic cycle will have a high SCR and volatility will be low enough to ensure financially efficient hedging as well as meeting Solvency 2 constraints. But in a bear market like 2007-2009, the cost of hedging shot up and put-spread strategies [7] therefore proved more judicious. In short, taking a static approach to hedging simply overlooks the fact that markets also change. Solve's periodic, and more discretionary, use of derivatives also helps add a strategy of selling very short-term calls, thereby reducing hedging costs.

How has the Solve strategy performed in its first 3 years? “*Returns have been in line with our objective, namely participating in upside, limiting volatility and maximum drawdown, particularly during periods of market turbulence, and maintaining SCR around 22%*”, says Michaël Nizard. The fund has returned an annualised +4.34% since its launch on 14/12/2015 [8], a good showing which is no doubt due to the fund weathering the downside triggered by worries over China at the beginning of 2016 and the Brexit aftermath. Annualised hedging costs have, for the moment, been limited to around 1.5% [9]. And despite EdR Equity Europe Solve's sophistication, the fund still depends on the DNA of Edmond de Rothschild Asset Management's European equity expertise. “*The fund reacted well during the February 2018 shock. It is not particularly defensive, but it avoids exposure to future interest rate rises, unlike some investments in less volatile stocks which can actually be more sensitive to this risk*”.

Frédéric Sadaca, head of overlay management at PRO BTP.

PRO-BTP: THREE GOOD REASONS TO HEDGE

The PRO BTP group is the construction sector's provident company. It has €15bn under management, of which around two-thirds in provident schemes (7% in equities) and the rest in French life assurance contracts (6%).

For Frédéric Sadaca, head of overlay management at PRO BTP, there are three main reasons to hedge equities when they are set against liabilities. “First, an investor's liabilities are generally indexed on interest rates, so it makes sense to keep equity volatility under control to avoid a disconnect between assets and liabilities. Second, liabilities may include items like a minimum guaranteed rate. Even when this is 0%, it lends some convexity to liabilities and it will be interesting to find that same convexity on the assets side thanks to a hedged equity solution.” And of course, Solvency 2 also plays a part: SCR will be less costly with hedged equity exposure.

(6) Data from 12/10/2007 to 06/03/2009, from 17/02/2011 to 26/09/2011 and from 13/04/2015 to 11/02/2016. Source: Edmond de Rothschild Asset Management.
(7) Buying a put at one exercise price and selling a put for the same quantity with the same expiry date but at a higher exercise price. The investor bets on a limited fall in the underlying stock.
(8) The track record above is for the R share, the fund's oldest share class launched on 08/12/2015, as of April 17 2018. With a minimum subscription of €500,000, the share is for all investors and especially for companies subject to Solvency 2 requirements. Please note that performance data for the R share differ from the C share due to fund fees: the R share has lower fees than the C share (a share which is open to all subscribers for a minimum subscription of one share (launch date 14/12/2016). Management fees for the C share are 2 % compared to 1.10% for the R share. The C share also has an outperformance fee, (15 % of any returns in excess of the benchmark index) unlike the R share.
(9) Source: Edmond de Rothschild Asset Management (France), Data at end March 2018

Benjamin Melman, directeur de la gestion Allocation d'actifs et dettes souveraines d'Edmond de Rothschild AM

> ❝ Looking to limit involvement in major market shocks can create value ❞

2018: A PARADIGM CHANGE HAS CREATED VOLATILITY

When at the beginning of the year, Benjamin Melman predicted that 2018 would be good for risk assets but would also see volatility returning, he probably did not expect to be proved right so quickly. "We have emerged from a world where equities were still attractive, central banks decisively expansionist and the global recovery rather soft. The lights have turned amber for equities and central bank policy, but the economic situation is clearly still on green with an unexpected stimulus plan in the US, a stronger-then-expected recovery in Europe and an economic transition in China which is, for the moment, going well".

For equities, Benjamin Melman prefers Europe. "Europe may not see the strongest earnings growth, but it looks like being the most robust". He thinks there is only a limited risk that an inflationary surge in the US might jeopardise the Fed's ongoing monetary normalisation but concerns over that possibility could trigger market instability. Above all, there is the risk of a return to protectionism, a theme that Donald Trump has put back on the agenda ahead of the US mid-term elections. This, for Melman, is a "very tricky issue for markets as nobody really knows what the consequences would be on global growth and company earnings. In such cases, markets create a risk premium and that is another source of volatility."

In other words, this is another good reason to opt for hedged equity strategies.

NOT ONLY A DEDICATED INSURANCE COMPANY SOLUTION

If the solution designed by Edmond de Rothschild Asset Management was prompted by the Solvency 2 directive which provides the equity capital consumption framework for insurance companies, mutual companies and provident institutions, Edmond de Rothschild Equity Europe Solve very quickly proved that its structure represented a real opportunity for all investors looking to take equity risk into account. Michael Nizard believes that "in a persistently very low interest rate environment where traditional equity selection approaches do not necessarily translate into reduced risk, there is an urgent need tohedge against equity shocks as markets are now more volatile and, in our view, likely to stay that way."

MAIN POTENTIAL INVESTMENT RISKS. The Subfund is a category 4 (on a scale of 1-7) or high risk/return Subfund profile which reflects its ability to have equity market exposure of between 0% and 100%. The risks described below are not exhaustive: it is the responsibility of investors to analyse each investment's risk and to come to their own opinion. Risk of capital loss: The UCITS does not guarantee or protect the capital invested; investors may therefore not get back the full amount of their initial capital invested even if they hold their units for the recommended investment period. Discretionary management risk: The discretionary management style is based on expectations of the performance of different markets (equities, bonds). However, the Subfund may not be invested in the best-performing stocks at all times. The same applies with respect to its exposure to one asset class rather than another. The Subfund's performance may therefore be lower than the investment objective, and a decline in its net asset value may lead to a negative performance. Equity risk: The Subfund may be exposed to the equity markets either via direct investments in equities and/or via financial contracts and/or UCITS or AIFs. Fluctuations of the equity markets may lead to substantial variations in the net assets which may have a negative impact on the performance of the Subfund. Therefore, the net asset value of the Subfund could drop in the event of a decline in the equity markets. The Subfund may present a risk and volatility profile that may engender sharper price fluctuations than those experienced by the global equity markets. The use of financial contracts with the aim of reducing the portfolio's exposure to equity risk is likely to modify the Subfund's risk profile. Risk associated with financial contract commitments and counterparty risk : The subfund is exposed to risks inherent to derivative products. Risks inherent to the use of futures, options and swaps include, but are not limited to: downward and upward fluctuations in the prices of options, warrants, swaps and futures, due to changes in the prices of their underlying instruments; gaps between the prices of derivatives and the value of their underlying instruments; the occasionally limited liquidity of such instruments on the secondary market. Entering into derivative contracts on the OTC market exposes the subfund to potential counterparty risk. In the event the counterparty to a derivative defaults, the subfund is liable to incur a financial loss. Use of derivative products may therefore generate risks of specific losses for the subfund, which it would not have been exposed to if such strategies were not implemented.

Edmond de Rothschild Asset Management (FRANCE), 47, rue du Faubourg Saint-Honoré, 75401 Paris Cedex 08. Société anonyme governed by an executive board and a supervisory board with capital of 11,033,769 euros. AMF Registration No. GP 04000015 - 332.652.536 R.C.S. Paris. Tél : +33 (0)1 40 17 25 25 - Fax : +33 (0)1 40 17 24 42. www.edram.fr