Conversations
with
Consultants
about
Categories

We have had many constructive conversations with consultants and advisors over the past year. And these highly intelligent and dedicated professionals all eventually ask us the same question: Are you fish or fowl? In the hierarchy of investment processes, the asset allocation work of consultants and advisors is the critical task.

Consultants and advisors need to know how to categorize our strategies and benchmarks. They need to know what the patterns of returns look like in varying market conditions. In this brief, we tell consultants and advisors how to categorize our strategies and where they should reside in the allocation firmament.

Kids prefer cheese over fried green spinach.

This little mnemonic has helped millions of students remember the Linnaean hierarchy of categories in the animal world: Kingdom, Phylum, Class, Order, Family, Genus, Species.

And it's a good thing, too, because categories matter: they help us organize our thinking about the world, inform our choices, shape our expectations about how they will serve us, even influence our appetites and emotions.

An informed consumer might be keenly interested in Japanese electronics and German cars but not Japanese wine or German food. Even if Japan produces some great wines (not sure about that one) and the Germans create some exceptional cuisine (they do), our categorical ideas work against those choices.

When Clothier Springs Capital Management launched our suite of hedged equity strategies in July 2010, we were indifferent to the category our colleagues in the consulting and advisory communities might assign them to. Call us "hedged," call us "alternative," call us "the alternative to alternatives," call us the best thing since sliced bread--just call us.

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For more information about Clothier Springs Capital Management and our suite of low-cost, liquid, rules-based hedged-equity products, visit our website:
www.clothiersprings.com

Going Where the Data Take Us

After all, the pattern of returns and the risk/return profile of our CBOE target benchmarks had been so robust and productive over the last two decades that we thought the numbers would speak for themselves. We also thought the fundamental simplicity, transparency and liquidity of our portfolios, our straightforward, rules-based, passive management approach and our low-cost pricing model would make it easy for advisors to slot our strategies comfortably into a category that worked in their asset planning and allocation models. We've had to do some fresh thinking.

After numerous conversations with consultants and advisors--the folks who generally organize their advice around the big levers of asset allocation--the need to explain our returnsets and their benchmarks became apparent. It also became clear that we needed to help guide that dialogue of discovery. While our strategies are tried and true and well understood by a select few, they are not widely used in the institutional asset allocation firmament. They combine a traditional long index exposure--which virtually all investment professionals understand--with a short option hedge--which markedly fewer investment professionals fully understand.

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"I'm looking for a hedge against my hedge funds."

It is in this realm of options where many investment professionals become uneasy. Options are a derivative and behave differently than traditional securities. They can be used either to expand risk or limit it, magnify returns or constrain them. Ultimately, they are simply return and risk modification tools. As such, and despite their ability to enhance portfolio returns and reduce portfolio risk, many of our fellow professionals have chosen to avoid the (prudent) use of options entirely. That is both our opportunity and our challenge.

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Based on the feedback we have been getting from consultants and a closer look at how our portfolios perform compared to some of the species that fall under the umbrella of the “alternative” phylum, we’ve got a definitive answer on the category question: our portfolios are first, last and always equity strategies. Their returns correlate very highly (90% or higher) to their long-only counterparts. And they may be the most productive equity strategies an investor can buy.

[O]ur portfolios are first, last and always equity strategies. Their returns correlate very highly (95% or higher) to their long-only counterparts.

Asset Allocation: Operating on the Big Levers

Consultants and advisors rightly need to know how to label or categorize any exposure that they will add to their allocation mix. As we can all agree that asset allocation is where the heavy lifting is done in a portfolio, consultants must understand the historic returnsets they recommend into a client portfolio: return patterns, averages, investment risks, and how they correlate with all the other exposures. The right blend maximizes return potential for any given level of risk. This defines the efficient frontier, the presumed target for any rational investor.

Our portfolios are the product of twenty-plus years of independently-generated real-market data (courtesy of the nice people at the CBOE) applied with radical simplicity. A basic, two-exposure mix in each of our strategies ensures a healthy exposure to a chosen equity market (S&P 500, S&P 400, Russell 2000, EAFE, EM, etc.), buffered and enriched by a rigorously-applied, options-based hedge.

We first came across the CBOE indexes in the mid-2000s, after an Ibbotson & Associates study effectively endorsed the basic Buy-Write strategy, based on the analysis of sixteen years of benchmark data. Since our professional backgrounds include both traditional portfolio investment and extensive options trading experience, the CBOE benchmarks and their radical simplicity resonated with us immediately.

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Structural Alpha

We undertook our own extensive analysis of the CBOE benchmark returns, both individually and as they impact a full portfolio allocation. Our conclusions agreed fully with the Ibbotson study: equal or better returns than the long-only benchmark, with significantly less risk. Moreover, when we include the hedged equity benchmarks in a portfolio optimization, they grab all the equity allocation from the long-only equity exposures. This makes intuitive and theoretical sense: an optimizer seeks the most efficient blend of assets. Including exposures that outperform with less risk will displace exposures with lower returns and more risk. This is the aim of portfolio optimization. It should also be the aim of every rational investor.

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The CBOE benchmark performance data continues to deliver better returns with less risk, now with twenty-two years of historic data. As of mid-2011, other major investment consulting firms have reached the same conclusion that we and Ibbotson & Associates did. They include EnnisKnupp, Callan, Fund Evaluation Group and Russell.

The Russell Research paper, from December 2010, references the low return expectations of most institutional investors, the concerns about risk and short term volatility, and the need to fund liabilities with required returns well above returns available in today's fixed income markets. As all investment professionals know, these issues are real and combine to make the most challenging investment environment in decades.

Hedging portfolios with short near-month call options is a strategy Russell advocates and supports with rigorous analysis. They could have written our marketing material. Our hedged equity strategies, passively managed at low cost to track the CBOE benchmarks, are a partial answer to those valid investor concerns and belong in the asset mix of anyone who requires equity exposure to meet their return objectives.

Self-Adjusting Hedge

These options-based hedged strategies also bring one additional and attractive characteristic to a portfolio: since option prices are very sensitive to volatility, these strategies collect more premium when markets are anxious. They work better when markets are fearful. This negatively correlated exposure works to benefit the strategy and the overall portfolio.

"I was spreading some risk around, and apparently it all wound up in your portfolio."

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There is no leverage in our portfolios and no market timing element in our decision making. We don't arbitrage positions or move between short and long, hedged and unhedged. Instead, we buy an equity exposure--the one the client requests--as cheaply as possible and keep it in place. We then sell a put or call against the long position and refresh that each month. Simple, straightforward, reliable and productive. We use separate accounts to deliver our strategies, not LPs, trusts or other legal confections. There are no black-boxes, lock-ups, re-caps, state secrets or confiscatory fees.

Summary

Our strategies are hedged, but not hedge funds. They are not alternative, because they correlate almost perfectly to long-only equity. They deliver superior risk-adjusted returns across all markets due to the reduced risk profile, which in turn is a direct function of the hedge. They deliver better returns than their un-hedged counterpart over the market cycle and especially in low return, sideways or down-markets. The known tradeoff is that they lag long-only in strong up-markets to a slight degree.

They improve the optimization and efficient frontier of any well-allocated portfolio that requires equity exposure. When included in an allocation, they improve the risk-budgeting equation, allowing for better returns with the same risk or the same return target with less risk. They use options in the most prudent way possible, enhancing portfolio returns while limiting risk, within the most basic, radically simple, two-exposure strategy.

These strategies may be hard to categorize, but their returnsets are too good to ignore. Everyone who consults to or advises institutional or private assets needs to know about these strategies and how to access them in the most efficient, liquid and cost-effective way.

There are more than twenty years of independent data to examine and understand. Liquidity and volume in the options markets continues to grow. The consulting community is increasingly studying and advocating for these simple yet effective strategies.

Add it all up and these now marginally used strategies will soon become portfolio mainstays for all the right reasons. Yet all these reasons reduce to just one important reason: They help clients fund their liabilities with greater certainty and less risk. And that's exactly what we all hope to achieve for our clients.

So it's true, after all. Kids prefer cheese over fried green spinach.

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