

The June Outlook

Market Stance

ASSET CLASS POSITIONING

We remain conservatively positioned in multi-asset portfolios

Commentary

- The recent rebound in equity markets has pushed global equity valuations once again above the usual range, largely reflecting extended US megacap ratings.
- Spreads in credit markets are tight.
- We expect slower growth and higher inflation in the second half of the year.
- The level of policy uncertainty is unusually high

Upshot

- Our multi-asset portfolios remain under-exposed to equities, and over-exposed to fixed income and alternatives - primarily hedge funds, gold and structured products.

INFLATION AND FISCAL RISKS

Global inflation is likely to increase due to new US tariffs and global countermeasures

Commentary

- Fixed income markets are pricing that this will be a 'spike' which will not be sustained.
- Longer-term inflation expectations discount a return to normality.
- Fiscal risks are rising in the US and elsewhere.

Upshot

Our fixed income exposure is limited to short and intermediate maturity bonds - longer-term yields do not fully reflect emerging risks.

THE GLOBAL ECONOMY

Global growth remains soft, with no recent signs of major deterioration, but caution remains warranted

Commentary

- Recent economic data have surprised to the upside, possibly reflecting higher spending ahead of tariff impositions, leaving a 'hole' to be filled subsequently.
- Higher tariffs are central to this pending dislocation, with uncertainty over these policies also undermining business and consumer planning.
- Lower oil prices are providing an offset, but not a full offset.

Upshot

- The coming months are likely to see a more evident loss in economic momentum, from a relatively weak starting point.

EXPOSURE TO U.S. ASSETS

The performance and the liquidity of US capital markets have led global investors to have high exposures to US assets. Is this still warranted?

Commentary

- The US Administration appears to want a lower dollar.
- Prospective legislation may impair the rights of overseas investors in US Treasuries.
- Fiscal risks are rising.
- Megacap US equities are once again on very high ratings.

Upshot

- We are at present underweight US assets in fixed income and equity portfolios, and currency hedges a significant element of these investments.

The Long Read

Hedging equity risks with options

SNAPSHOT

1. Why Use Options for Hedging

Put options offer downside protection while allowing upside gains. The trade-off is the premium cost, which can reduce returns in rising markets.

2. Complexities of Option Hedges

Premiums rise with volatility, making hedges costly in stressed markets. Options protect best in sharp declines but may underperform in modest drops. Timing matters—hedges are more efficient when added in calm markets.

3. Real-Time Management

Option performance depends on maturity, strike, and volatility shifts. Active oversight is required to maintain hedge value.

4. Cost-Reduction Strategies

Use cheaper structures like out-of-the-money puts, put spreads, or longer-dated options to balance protection and cost.

5. Our Tactical Approach

Avoids constant hedging. Deploys options only when: risks are underpriced, volatility is low, and the outlook is unclear.

6. Recent Implementation

Hedges were added during calm but uncertain periods—protecting during the August and post-‘Liberation Day’ sell-offs.

Equity hedges in our multi-asset portfolios

In recent articles in our ‘Portfolio Perspectives’, we have addressed the complexities of managing multi-asset portfolios in periods of political and economic turbulence, focusing in particular in this environment on gold, minimum volatility equities, hedge funds and structured products.

This month, our focus is on using options markets to hedge downside equity risk. We have been active users of these instruments in recent months, and to a greater extent than has typically been the case in the past. We set out some of the complexities associated with an options hedge, and the investment framework we use in considering the strategy.

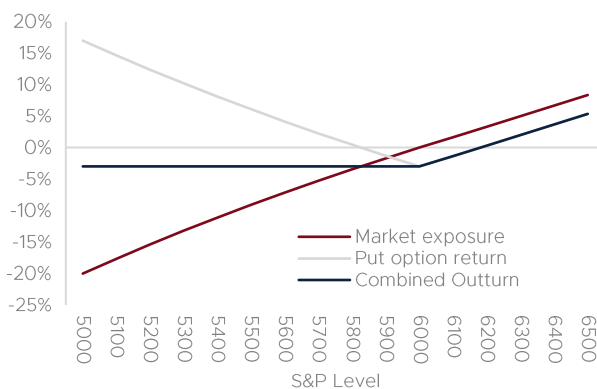
Why have an options hedge?

The basic attraction of owning put options, which give the right but not the obligation to sell the asset at a predetermined price and time, is the asymmetric payoff they provide. If the underlying market associated with the hedge falls, the option would gain in value, providing protection. If the market continues to rally, however, the maintenance of a long equity exposure allows for full participation, while the loss is limited to the premium paid for the option.

Chart 1 provides an example. Exposure to the equity index leads to a significant loss if the S&P500 falls from say 6,000 to 5,000.

CHART 1

Decomposing returns to an options strategy (for different levels of the S&P 500)



Source: Saranac, Standard & Poor's

The Long Read

Hedging all of the equity exposure with an option with a strike price of 6,000 offsets much of the market decline. However, assuming a 3% premium for the option, there is not a perfect offset. Moreover, while the option allows for upside participation in the event of the market rising, the option premium still acts as a drag on returns.

Some complexities of an options hedge

1. Costs: options do not come for free

The asymmetric payoff has a rough vernacular translation of “you can have your cake and eat it”. However, like most things in life which are too good to be true, reality intrudes when using put options to apply a hedge. Sadly, they do not come for free.

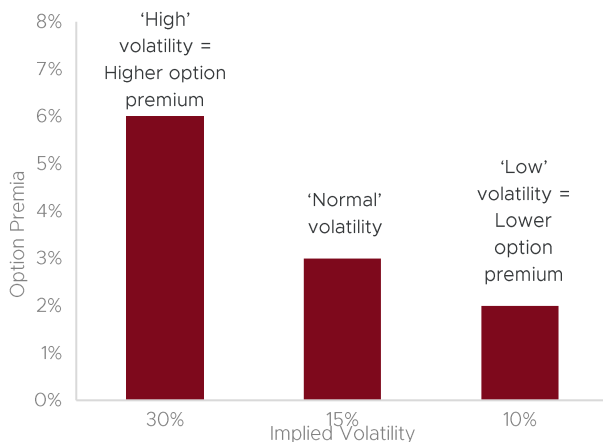
There is no fixed price for an option with characteristics such as the period to maturity and the strike price relative to the prevailing market price. Rather they vary in particular with the market assessment of forward-looking volatility.

The higher this implied volatility, the more likely is the market consensus that even a quite extreme price level of the asset being hedged may be reached. This implies a greater chance that the option will be valuable, hence the higher the cost.

Chart 2 sets out some broad indications of options pricing for the S&P500.

CHART 2

Option premia for 3-month S&P 500 option, at different implied volatilities



Source: Saranac, CBOE

We assume a 3-month maturity, with the option struck at the assumed market level of 6,000 (and for simplicity we assume zero interest rates and no dividends). We also assume three levels for implied volatility: a 'normal' level of 15%, a low level of 10% and a high level of 30%. It is clear that different implied volatility levels have a material impact on the premium paid and the potential returns from a hedge.

When implied volatility is at say 30%, as it would be in a stressed market environment, the premium would be around 6%. As a result, a 10% market correction would deliver only a 4% net return to a put option hedge held to maturity. This illustrates the point that by the time market stresses are widely perceived, the cost of an options hedge can quickly become prohibitive. By contrast, a hedge established in a low volatility environment would allow a put option to match more closely the market decline - but still not the full extent of it.

This demonstrates that, as a generalisation, options hedging strategies really pay off only on very substantial market declines, with the associated costs constraining the returns in a more 'normal' correction, sometimes to a material extent. We regard recognition of this as integral to implementing an effective hedging strategy. It can be easy to succumb to the temptation of regularly establishing put option hedges, but it can often be the case that the cumulative costs can offset any enhancement to returns over long periods of time. A more discerning approach is therefore required.

In our view, a question that always needs to be considered before implementing options hedges, which do not come for free, is 'why not just sell equities?'. Indeed, if there is a very strong view that equities will correct by say 20%, the most appropriate course of action would be to bypass the options hedge and simply reduce the equity exposure - particularly if options premia are already very elevated. So, the environment in which an options hedge provides highly effective protection is actually one in which, after the event, a hedge is only the second-best option. This requires a disciplined investment decision-taking framework which establishes the environment in which options hedges can be justified.

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Our broad approach is set out in the final section of this paper, with some recent live examples. However, we first note some additional complexities associated with put options hedges, to highlight the wide range of judgements which need to be incorporated into such a framework.

2. Options price changes don't always match market moves

The apparent simplicity of an option's return if held to maturity conceals much greater complexity when its path to maturity is evaluated. This path is affected by complex interactions between the price at which the option is struck, the maturity of the position, and changes in implied volatility and interest rates. As a result, an options exposure requires continuous evaluation while it is 'live', rather than simply being left to run to maturity, because its hedging properties change as market conditions change, and as the option's time to maturity diminishes.

Consider first a very basic hedge: a put option is struck at the prevailing market price on the S&P500, with a three-month maturity. If the market falls by 10% by the end of this period, the option will deliver full protection against this 10% drop if held to maturity, less the costs. At least initially, however, the option's rise in value will not match the full extent of the market's decline. As an approximation, immediately after implementation, it will capture initially only around half of the price fall. If the market decline continues, the incremental degree of capture will increase, and when the option is very 'in the money' it will move in line with the S&P index.

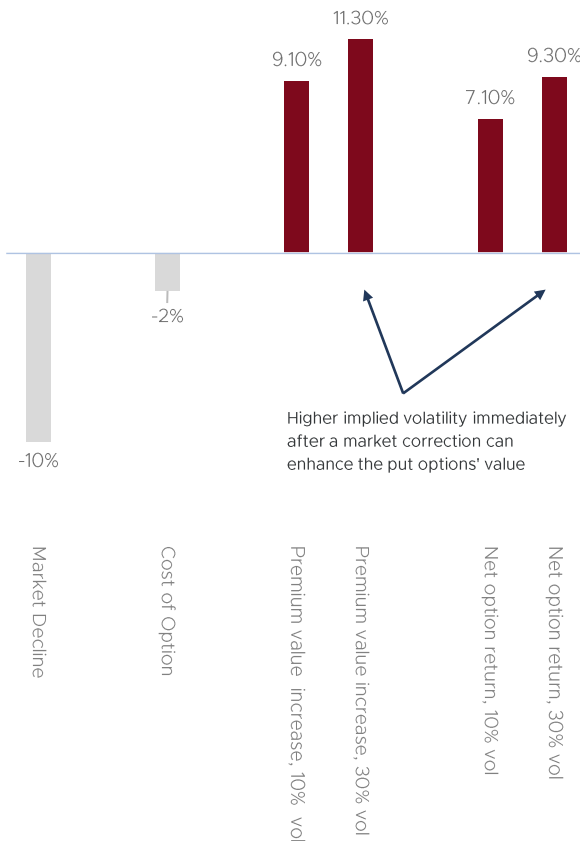
This initial dampened response of the option's premium to changes in the asset can limit its effectiveness as a hedge. Assume an equity market correction of 10% immediately after the option was struck, and that the market is then judged to have reached a new floor and is likely to rebound. In these circumstances, it would be sensible to sell the option and lock in profits. However, the option value's increase on the fall would not have captured the full extent of the market decline, as the premium value would only have increased by 9%. This hedging 'slippage' when added to the cost implies a return of 6%, against the market decline of 10%. This is of course nice to have, but it is still some distance from providing a 100% hedge –

as would have been the case if the equities simply been sold and bought back. However, because options exposures are complex, it's necessary to consider one further aspect of the exposure.

As noted, implied volatility is a highly important determinant of the price of an option. Sudden declines in share prices are usually associated with significant rises in implied volatility, which raises the value of all options. So it may be the case that the rise in volatility provides a better price to unwind the option and indeed could provide a return which exceeds the market fall. Chart 3 illustrates the impact of these different components.

CHART 3

Contributions to Returns From Option Hedging Strategy*



Source: Saranac, CBOE

* Assumes a 10% correction immediately after implementation

The Long Read

These examples demonstrate that real-time tactical oversight of an options hedge, involving the evaluation of a range of influences on the price, is important. A simple comparison between the market price and the strike price presents only a partial picture of the option's value at a point in time.

3. Options costs can be reduced, but at the expense of a less effective hedge

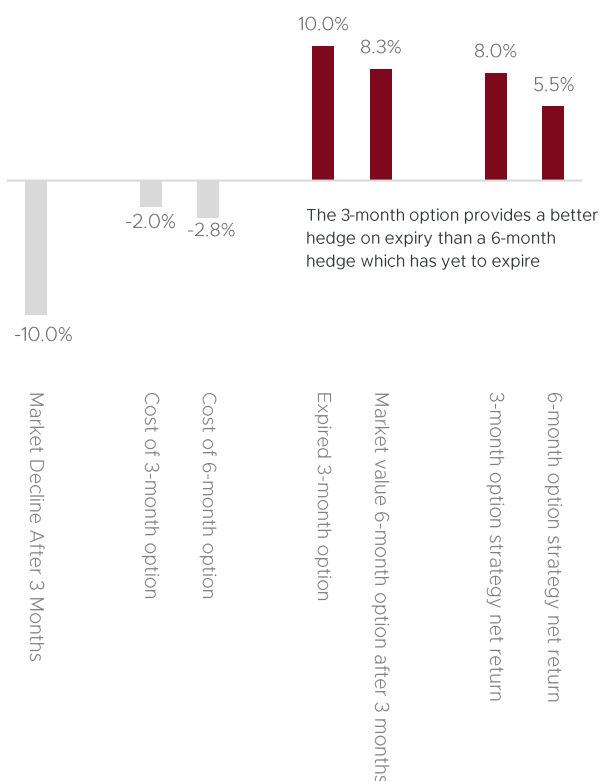
We noted that cost can be a significant factor which dilutes the effectiveness of an options hedge. We set out below some steps which can be taken to control costs. All of these, however, dilute the effectiveness of the hedge, and require a judgement in particular market circumstances as to the appropriate course of action.

- For example, the hedge could be struck at a price lower than the prevailing spot price of the underlying asset, although the hedge would then only become effective further into an equity correction.
- Alternatively, an additional put option could be sold below the strike price of the purchased put, with the option premium offsetting to some extent the premium on the initial purchase. However, this would also remove protection were there to be an extreme phase of an equity market correction, with prices falling below the sold put's strike price.
- If a maturing option were likely to be replaced with a further option, it would be less costly to buy a single option with a maturity covering both periods. For example, the cost of a 6-month option is around 40% higher than a 3-month option, not double the price. However, longer-dated options with strike prices close to the prevailing market price are typically less sensitive to equity price changes, as there is more time for any price fall to be reversed. As a result, the response of the options price to changes in the underlying asset is initially dampened, so that any rise in the option's price on a market fall would be less compared to a shorter-dated option (chart 4). This sensitivity does, however, rise the more the option moves 'in the money', and the sensitivity eventually becomes greater.

However, when the option is struck, that's not where an investor is, and those early stages of a market correction do matter.

CHART 4

Longer-dated options can be cheaper, but also less sensitive to market declines



Source: Saranac, CBOE

There is not a perfect answer. Simplicity is often the best strategy, but depending on market pricing, all of these choices are legitimate when considering a hedge, and in different market circumstances we have implemented all of these variations over time

4. Our use of options hedges

Three approaches to using options: always, never and tactically

There are three broad approaches to using derivatives to hedge risk.

The Long Read

- First, implement a permanent hedge, with a portion of the portfolio always allocated to put options. This would by definition control downside risk, but it would also raise portfolio costs and so impair returns. There is, therefore, no guarantee of enhanced performance associated with this strategy. Similar results could be achieved simply by running with a lower equity weight, but with a less complex portfolio.
- A second approach is always to eschew the use of options, either because of the costs and complexity associated with their use, or for more prosaic reasons if platform constraints make implementation too problematic.
- The third approach, and the one which we deploy, is to use options as hedges, but only when three market conditions are met.
 1. Markets are rising or consolidating gains and appear to be in a 'risk-on' phase, but in which potential challenges are under-priced. We would characterise this condition as 'slightly speculative'.
 2. In these circumstances, implied volatility is likely to be relatively low, allowing hedging costs to be controlled. Low hedging costs tilt the balance towards options rather than equity sales, because it allows the equity exposure to be maintained rather than forcing an abrupt market timing decision (and timing market peaks precisely can be challenging).
 3. A further condition is when the market outlook is still somewhat ambiguous – significant downside risks combine with ongoing upside potential. By contrast, a strong view that equity markets are likely to fall would be much better expressed through outright sales of equities.

Since these conditions tend to be unusual, for much of the time we do not have equity hedges. However, we felt that the conditions conducive to an options hedge started to become evident last summer, and then to a greater extent around the turn of the year. The ambiguous market outlook was an important element of our thinking. While we were concerned about the potential adverse market impact of some of the new US Administration's policies, it was nevertheless unclear what would actually be done, and when.

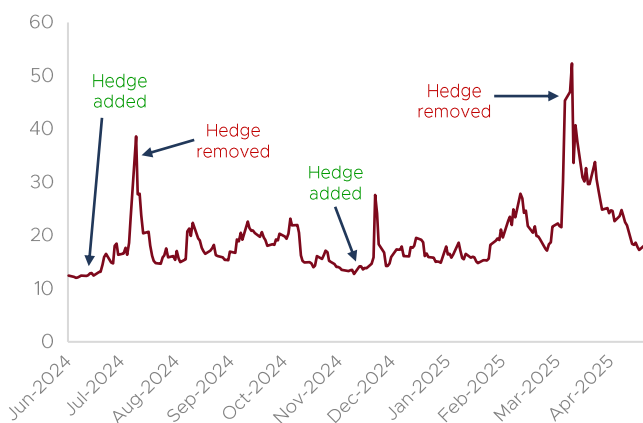
If politics becomes the main drivers of markets, the range of possible outcomes becomes larger, and options become more attractive.

Recent option hedges in our multi-asset portfolios

Put option hedges were in place in our multi-asset portfolios for a period last summer, providing protection in the August sell-off, during which some profits were taken on the hedge. However, high implied volatility made re-establishing the hedge unattractive at the time. Nevertheless, hedging became attractive again towards the end of the year as implied volatility fell back significantly (chart 5).

CHART 5

Implied volatility and timing of our hedges



Source: Saranac, CBOE

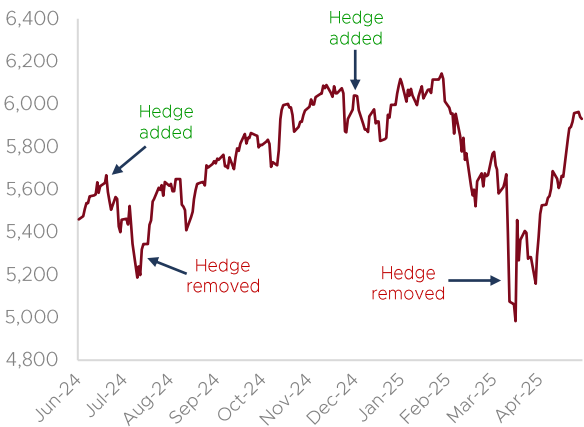
Positions implemented at that time covered around 20% of the equity exposure for middle and high-risk multi-asset portfolios, but for approximately half the equity exposure for lower risk investors who may be more concerned about capital losses.

These puts became very valuable in the market sell off after 'Liberation Day' on April 2nd, benefiting not simply from the fall in the market (chart 6), but also because of the rise in volatility. They were sold in phases not too far off the market floor, adding around 0.5% to portfolio returns in this period.

 The Long Read

CHART 6

S&P500 and timing of our hedges



Source: Saranac, Standard & Poor's

These hedges have not been reinstated, because implied volatility, while falling, has remained too high to warrant further protection. However, consistent with our general philosophy in this area, and the still-ambiguous market outlook, hedges would be re-established if option premia costs were to fall to more attractive levels. These levels were being approached at the time of going to press.

In addition to owning put options that offer protection on US equity markets, we are constantly evaluating the most attractive risk-adjusted hedging opportunities for portfolios. These may include owning protection on other geographies, or even asset class (e.g. high yield bonds), earlier this year we positioned for a rise in equity market volatility itself by owning call options on the VIX index, a hedge that also played out nicely in April's market turmoil.

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