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Time to protect your assets

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One of George Soros's hedge funds took out protection late last year, and others are following suit. Source: AP

THE sharpest investors know that the best time to take out downside protection is when the market's enjoying a bull phase and insurance strategies are cheap.

For instance, recent US Securities and Exchange Commission disclosures revealed that one of the most successful hedge funds of all time, Soros Fund Management, had taken out sizeable downside protection over its S&P 500 portfolio during the final quarter of 2013. At that time, this protection represented the fund's single largest position.

Traditionally, this downside protection has been realised through the purchase of exchange traded, or over-the-counter, put options over either single positions or entire indices.

Nearly six months later and the rest of the market are beginning to play catch up. Discussions about Soros's position are becoming more frequent and many sophisticated investors are starting to think about the potential downside risks that exist in their index-heavy portfolios.

Nowhere is this more evident than here in Australia. Increasingly, investors are looking for advice on what is currently cheap, what's expensive and how suitable are these opportunities for self-managed superannuation funds. There appears to be no better time to consider portfolio protection measures for all Australian investors.

This is because both US and Australian stockmarkets appear to be hovering near record levels but without the heightened volatility often seen when markets rally.

This means that reasonable volatility levels are priced into downside protection choices. These levels can be measured in Australia via the S&P/ASX 200 VIX Index, colloquially referred to as the A-VIX index.

Furthermore, many single position and portfolio protection strategies are now allowable within Australian SMSFs.

So in essence this means that downside protection choices are currently cheap, stockmarkets are relatively expensive — based on fundamentals — and that there is no more prudent time than now to consider appropriate protection strategies for Australian SMSFs.

Within the Ultra High Net Worth investment community, this conversation has centred on how best to achieve this protection and what are the alternatives for managing market risk.

The need for more versatile solutions was realised during the global financial crisis when investors required a greater choice of hedges and better pricing.

The issue of pricing was due to the fact that these products relied heavily upon a valuation model that reflected the stockmarket's volatility levels. The GFC, however, caused many extreme spikes in these levels and therefore made these hedging solutions punitively expensive.

Shortly thereafter, a newer generation of downside protection solutions began to be offered in Australia. These solutions protected portfolios more accurately and were better priced thanks to the fact that they no longer relied upon volatility-sensitive valuation models.

Adopted from Europe and referred to as "delta one" products, they had proven themselves abroad to be versatile during all market conditions, regardless of volatility.

They have now allowed Australian investors to more comprehensively protect their entire portfolios, which may include commodities, real estate assets and debt market instruments.

Even though we have not yet seen a recent downturn in our market, the above hedge fund example highlights that the active global investor attempts to stay one step ahead of the market at all times. These global investors know that we need to prepare for the turn; if we can see it, it's already too late.

These tenured global investors also know that if we keep one step ahead of the market, we're proactive; but if we think we're two steps ahead, we are sure to run into folly.

Therefore, the key to implementing these strategies is timing, and the time appears to be now.

Global investors agree that there exist dislocations between current market prices and fundamental valuations. There is an emerging consensus that stocks are expensive, based on simple measures such as price/earnings ratios or the more robust valuation measures such as the cyclically adjusted price/earnings ratio, known as CAPE, which is a measure of prices divided by their average of 10 years of earnings, adjusted for inflation.

We know that this is attributable to the reflation measures undertaken by the US Federal Reserve, Bank of Japan and other central banks around the world.

We also know that these reflation measures are unorthodox and without precedent. They are an experiment where the outcome is unknown.

It then becomes important that when these central banks begin to wind back these measures in the years to come, Australian investors and particularly SMSFs find ways to protect against these unknowns.

In particular, a legacy issue for many Australian SMSFs is a disproportionate weighting of Australian bank stocks within their portfolios. Many of them held the shares since they were either demutualised or listed during the 1980s and 1990s. Selling down these positions may trigger capital gains tax liabilities.

Therefore, as Australian banks appear to be fully valued in this market and as it becomes clearer that these institutions are competing in a subdued credit growth environment, now is the time to protect entire portfolios and overweight sector positions, such as Australian banks.

There are several practical ways Australian SMSFs can achieve this. Single stock positions can be protected using a quoted MINI short warrant or the more traditional listed single stock put option. If the SMSF needs protection against an entire sector, a more cost-effective hedge is often achieved by taking out protection over a sector exchange traded fund or one of the new sector-linked products now available, on and off market.

Making portfolio protection decisions does not mean we believe bad times are immediately ahead, but building wealth involves managing risks at all times.

The UHNW investment community has also explored the other options for managing this market risk. Managed funds that champion what are referred to as "portable alpha" strategies have become topical in the past six months, particularly as regional agribusiness opportunities have increased. Larkin Group, for example, is in the process of building what's referred to as a protection fund, which during positive markets runs at a loss but adds value when momentum turns, often sharply. These are already being customised for individual wholesale clients here in Australia and across the region.

Downside protection is like brakes on a racing car, allowing you to go faster without fear of hitting a wall and losing all those hard-won gains. Including portfolio protection in our decision- making is very important.

Larkin Group is a wholesale wealth adviser focusing on high-yielding regional investments.
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