Earning returns from dynamic hedging

What was the problem that needed to be solved?

Liability driven investment (LDI) is widely used by pension funds for risk-reduction but that means a large part of the portfolio offers low or negative real returns. Our clients needed an innovative way to increase returns on their portfolio.

Our challenge: could we dynamically manage LDI to earn a systematic return?

How did we help?

We took inspiration from our clients who asked – "*can we time our hedging programme so we don't buy when prices are high*" and "*can we dynamically reduce as well as increase our hedge?*"

No one had done this before; to succeed we would need a great team and a good process.

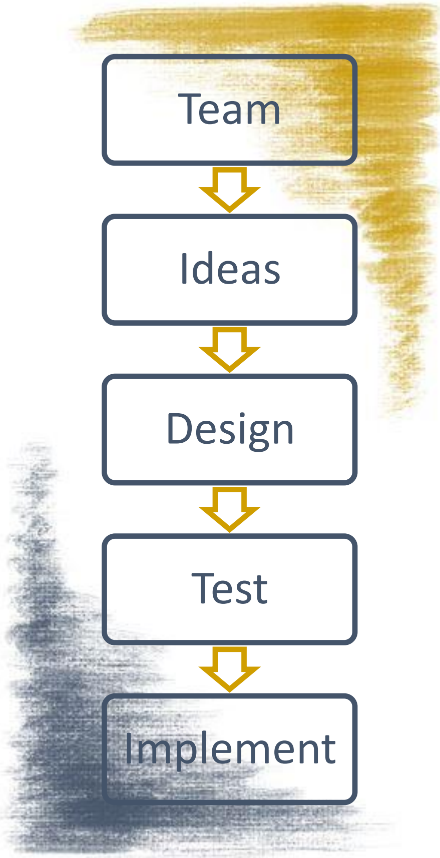
We followed a 5-step process, first we built a team of specialists with diverse and complementing skills including portfolio management, risk, pensions, gilt markets and options trading.

Then we brainstormed for ideas. One of these was to earn a systematic return, akin to the premium for selling options using dynamic hedging.

The team worked together on the design. In essence, we devised a buy-low; sell high approach. The theory said this would produce steady returns in a wide range of conditions and that the return would be uncorrelated with traditional sources of return but would it work in practice?

We tested the design extensively, looking at historical and hypothetical scenarios to establish how refine the design.

Finally, we found the best implementation structure, making the strategy scaleable and making sure that the fund structure was cost effective and appropriate for pension fund investors.



We did something that had not been done before by building the right team and following a clear process

What objections did we face?

While the theory showed steady returns, we needed to be sure that it would work in reality. For example, would trading costs reduce our returns? We commissioned testing on the impact of trading costs, particularly in times of market stress. This testing gave us further insights; showing that the strategy was well positioned for trading in normal markets and even better in stressed markets.

What was the outcome?

Pension funds now have access to a cost-effective and practical strategy which earns a systematic return from their hedging portfolio. This strategy does particularly well in times of high volatility as we have seen over the last 3 years.

◆ a systematic source of return ◆

◆ uncorrelated with other sources of return ◆

◆ much lower fees than actively managed strategies ◆

◆ benefits in times of gilt market volatility ◆

◆ works in up and down markets ◆

◆ protects against falling rates ◆

◆ fits with a pension fund's "utility function" ◆

◆ does not disrupt detailed hedging programme ◆

Want to learn more?

If you'd like to know how Investment Governance Services can be part of your team and work with your advisors and investment managers to help you identify and implement the solutions you need, please get in contact.