

Managing Risk in your Client Portfolios: the Case for Hedged Equity

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Presented By



fa-mag.com



Our Speaker – Wayne Ferbert

Alpha DNA Investment Management, Co-Founder and Managing Director

Co-author of the book: *Buy & Hedge*, an investment guide for hedging your equity portfolio

Our Objectives for this webinar

1. Review Six Common Risk Management approaches implemented by Advisors
2. Discuss the Benefits of Hedged Equity
3. Present Alpha DNA's Hedged Equity strategies

1. Cash
2. Tactical management (ie, risk on / risk off)
3. Defensive Stock Bias
4. 60 / 40 Balanced Portfolio
5. 'Endowment' Asset Allocation
6. Index Hedging / Hedged Equity Managers

We'll lay out the Pros & Cons of each of these approaches from the point of view of the Financial Advisor and their clients

1. Deploy more Cash in Client Portfolios



Pros

- ✓ Will not lose value



Cons

- ✗ Will not gain value
- ✗ Difficult to time the increase and decrease in Cash positions
- ✗ Managing Client expectations

While Cash can be a very stable part of a portfolio, getting the timing right in its use is difficult for most advisors ...

2. Tactical Management



Pros

- ✓ If you or your manager time it right, it can add significant value to the client portfolio



Cons

- ✗ Most Tactical Managers do not add value over long horizons
- ✗ Difficult Manager Selection

Timing the market is a very difficult exercise and most tactical managers do not add value over the long horizon

3. Defensive Stock Bias



Pros

- ✓ Low beta nature of these stocks tends to support the portfolio during market declines, on a relative basis
- ✓ Well understood approach that can be replicated by advisors



Cons

- ✗ Lower returns come with the lower risk profile
- ✗ Advisor must still solve for stock selection or hire 3rd party manager – so manager selection will matter

Lower risk will produce lower returns – so the advisor must determine whether the client can still achieve her goals given the lower returns



Pros

- ✓ Well understood, well accepted, and easy to access
- ✓ Low cost to implement



Cons

- ✗ Fixed income tends to be correlated in displaced markets
- ✗ Low Interest rate environment creates appreciation challenge to bonds in near term

The current historically low interest rate environment has bonds trading near all time highs – making bonds an unlikely asset class to appreciate in any market sell off

5. Endowment Asset Allocation



Pros

- ✓ Well understood approach that can be replicated by advisors
- ✓ Broad diversification can smooth the bumps in the markets



Cons

- ✗ Significant reliance on manager selection
- ✗ Additional asset classes are the least: followed, liquid, accessible, affordable

This approach has merit but advisors need to become experts on asset classes they likely have little experience with

6. Index Hedging / Hedged Equity Strategies



Pros

- ✓ A well constructed index hedge will confidently be inversely correlated in a downward moving market.



Cons

- ✗ Most advisors lack experience implementing hedges
- ✗ Manager selection matters in this space as performance variance is very high in this space

We believe this approach is the most effective and straightforward for Advisors to implement for clients – but manager selection is the key!

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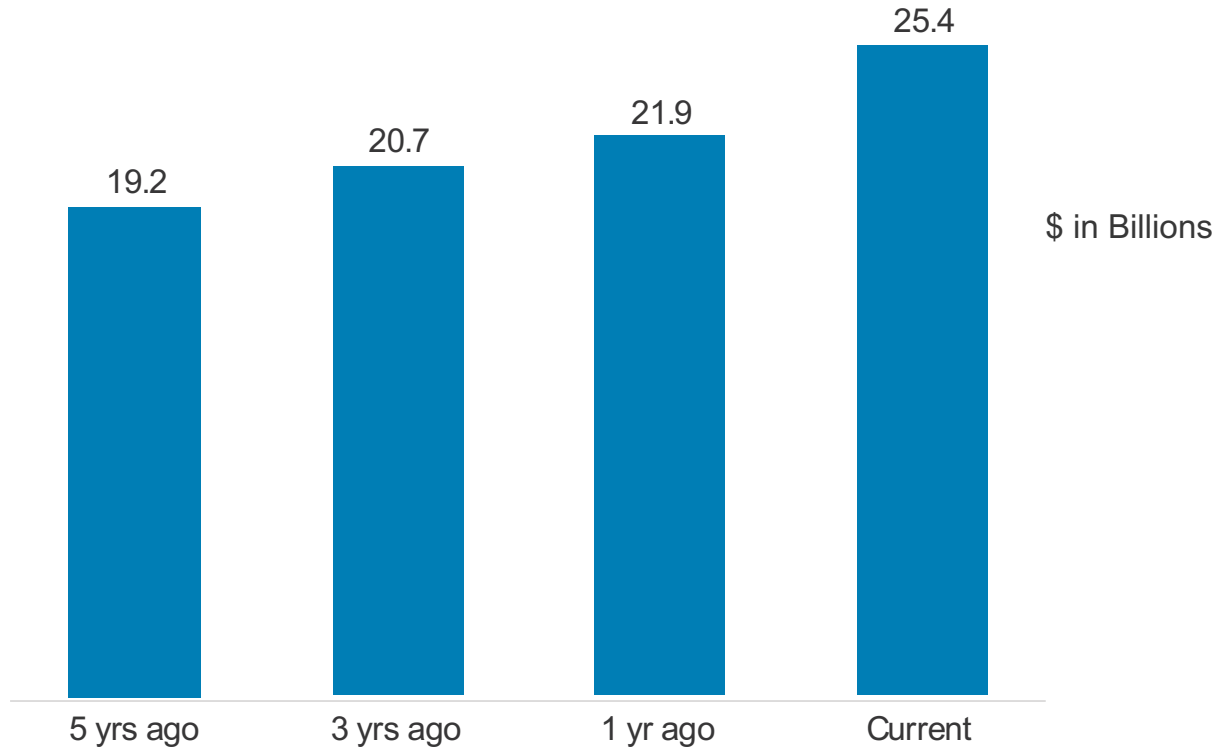
The appeal of Hedged Equity is powerful:

Capital Appreciation and Downside Protection

Balanced together in one strategy

Assets invested in hedged equity category

AUM for the all of the open-ended mutual funds that Morningstar categorizes as derivative hedged equity that have at least a 5-year track record at Dec 31, 2020

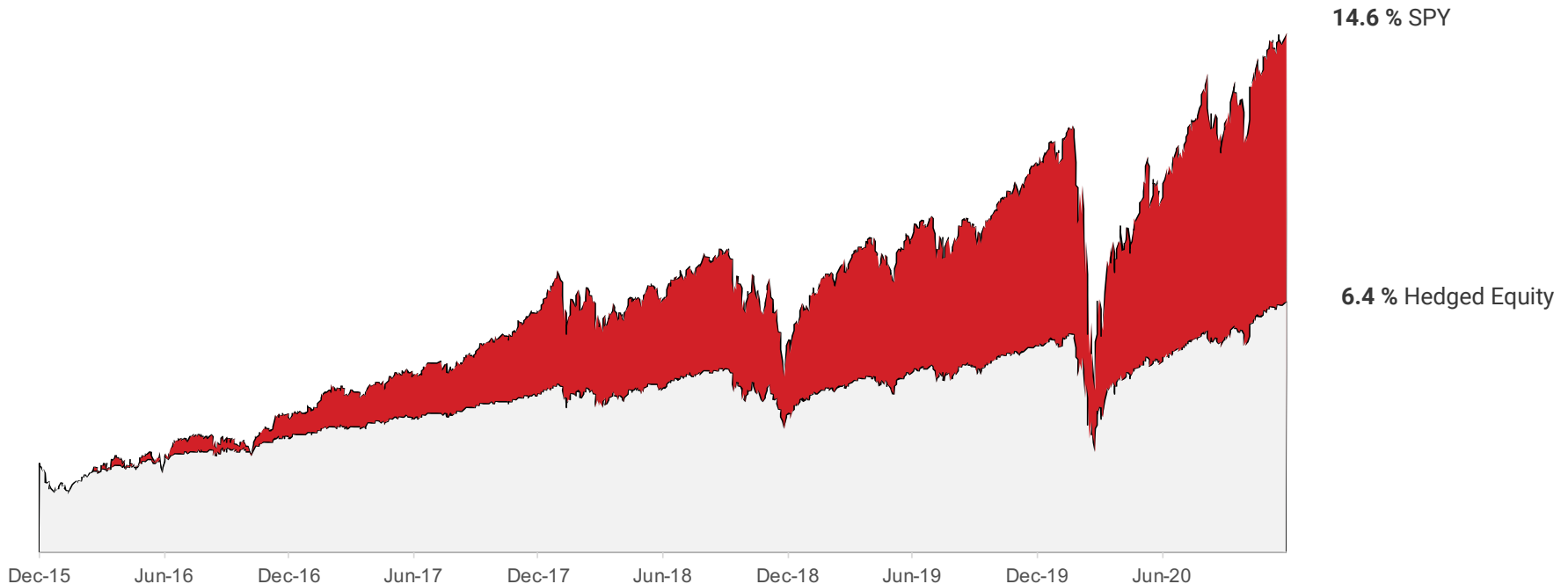


Source: Morningstar for the 30 funds in the category / Ycharts for the AUM data

Capital appreciation over time

S&P500 ETF vs. Average Hedged Equity Strategy
2016-2020

5-year Compound
Annual Growth Rate



Source: Alpha DNA – Hedged equity data represents the daily returns compounded daily of the 5 largest funds as of December 31, 2020 that have at least a 5-year track record in the Morningstar category Derivative Hedged Equity.

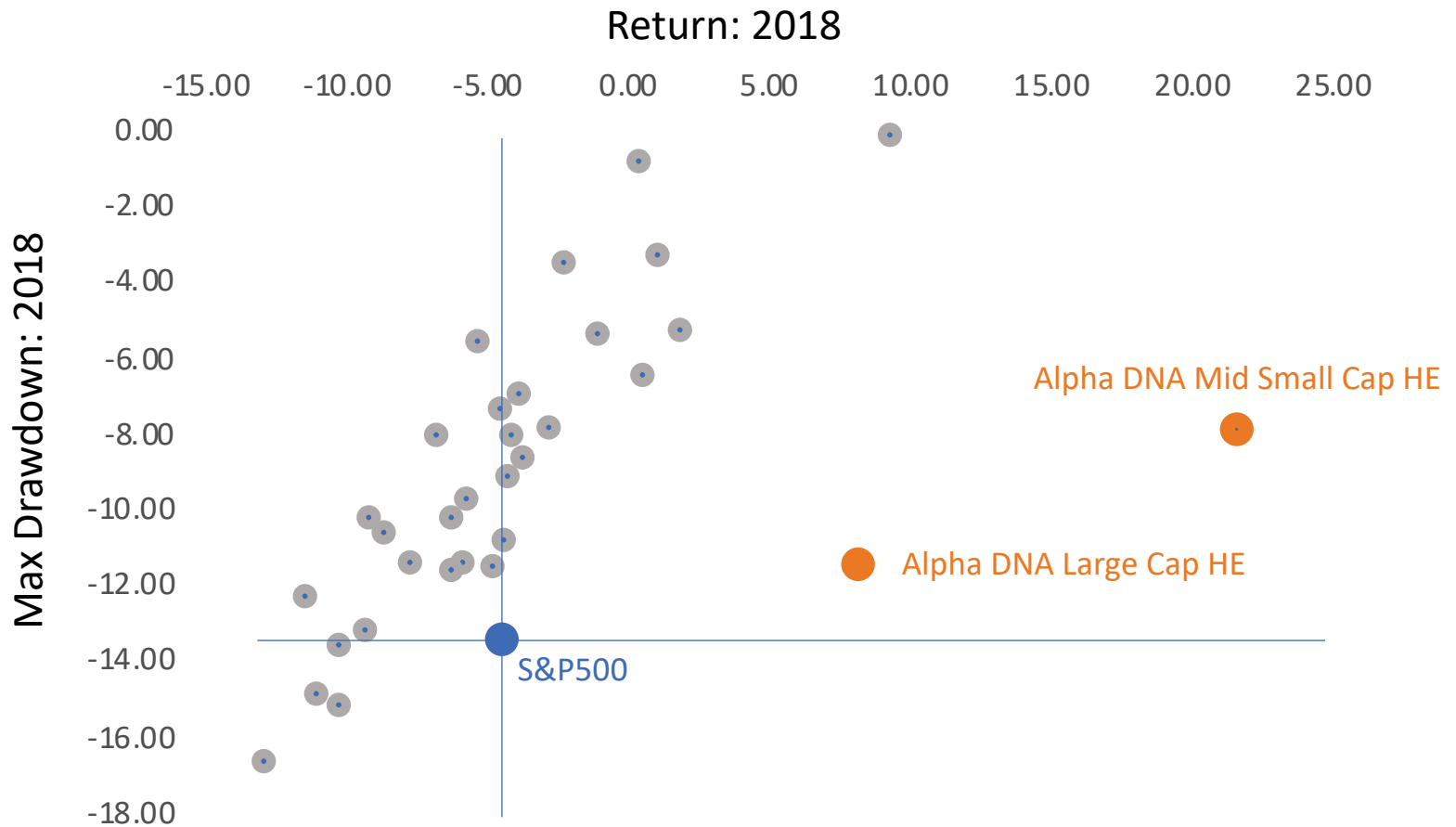
The Components of (nearly) every Hedged Equity Strategy

1. Equity exposure
2. Hedge that provides downside protection
3. Additional tactics deployed to fund the cost of the Hedge

As an Advisor, you will need to perform a thorough diligence to find the managers that can deliver in Hedged Equity on the promise of Capital Appreciation and Downside protection in the same portfolio.

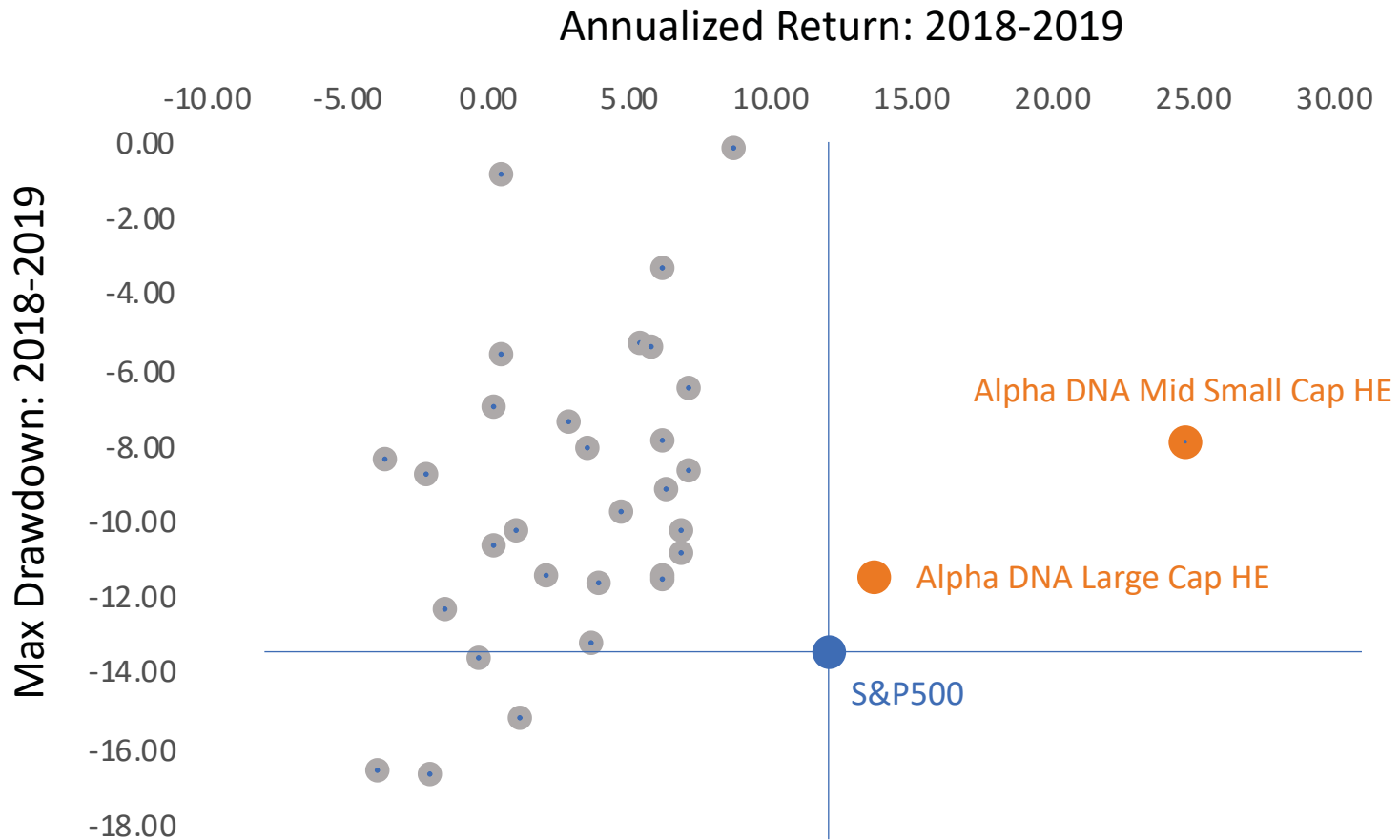
1. Identified the 30 largest Hedged Equity Mutual Funds according to Morningstar with at least a 3 year track record
2. Present the 1 year, 2 year, and 3 year returns
3. Chart the Annualized Returns against the Max Drawdown

Top 30 Largest Hedged Equity Mutual Funds According to Morningstar



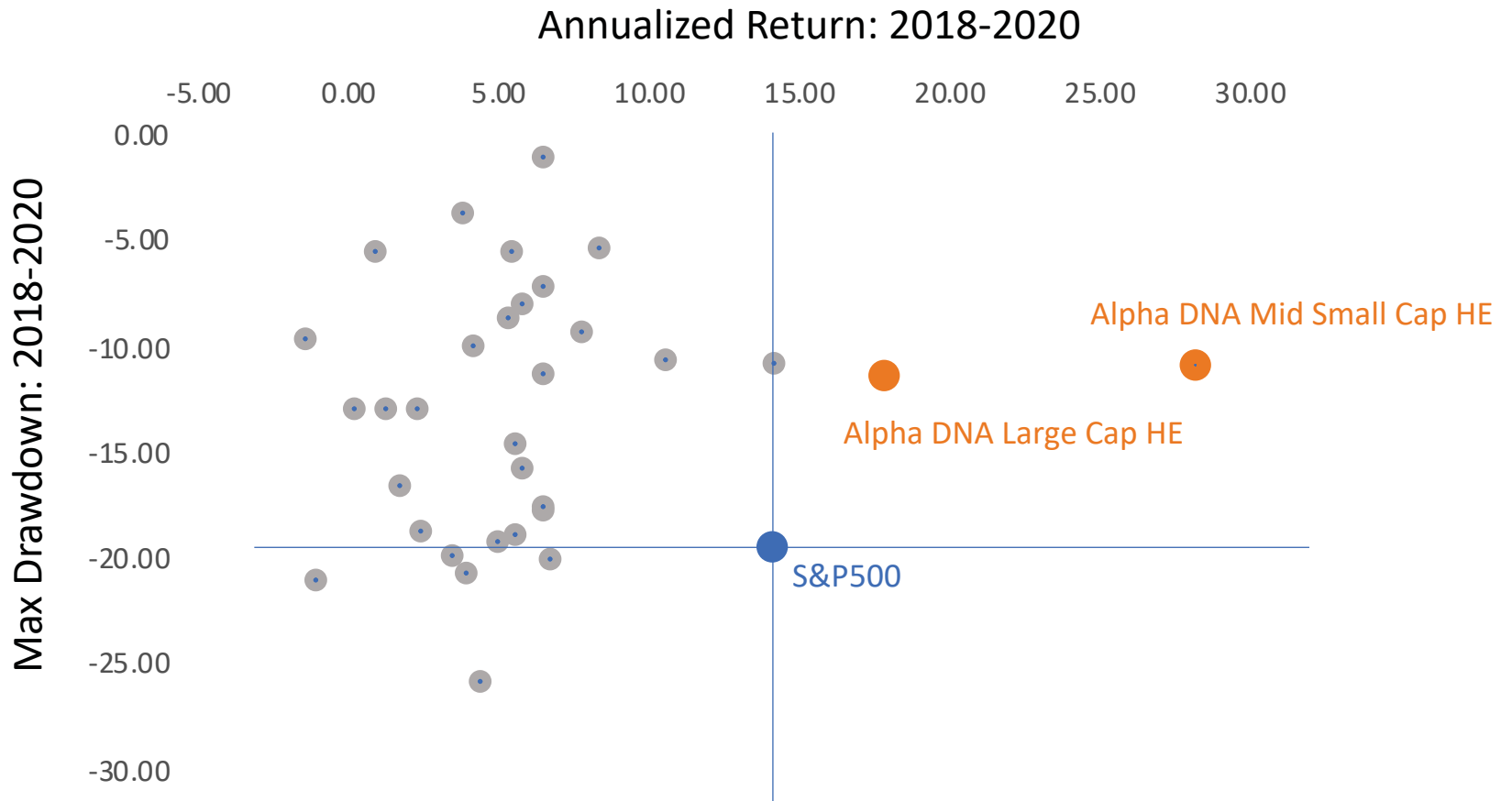
Source: Morningstar. Note that Morningstar reports Max Drawdown based on MONTH END returns – not daily or intraday returns. The actual daily max drawdowns would be higher.

Top 30 Largest Hedged Equity Mutual Funds According to Morningstar



Source: Morningstar. Note that Morningstar reports Max Drawdown based on MONTH END returns – not daily or intraday returns. The actual daily max drawdowns would be higher.

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Alpha-DNA Hedged Equity: Strategy implementation



Always Invested

- Screen ~3,000 stocks
- Systematic stock selection using machine learning and alternative data
- Identify stocks with Revenue upside in near quarter
- Invest in 80-100 equal weight stocks
- Stocks are typically around 95% of portfolio

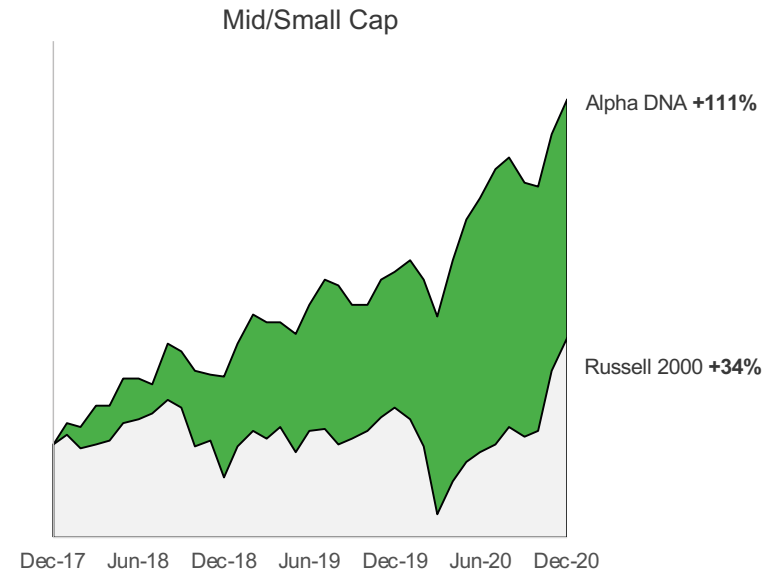
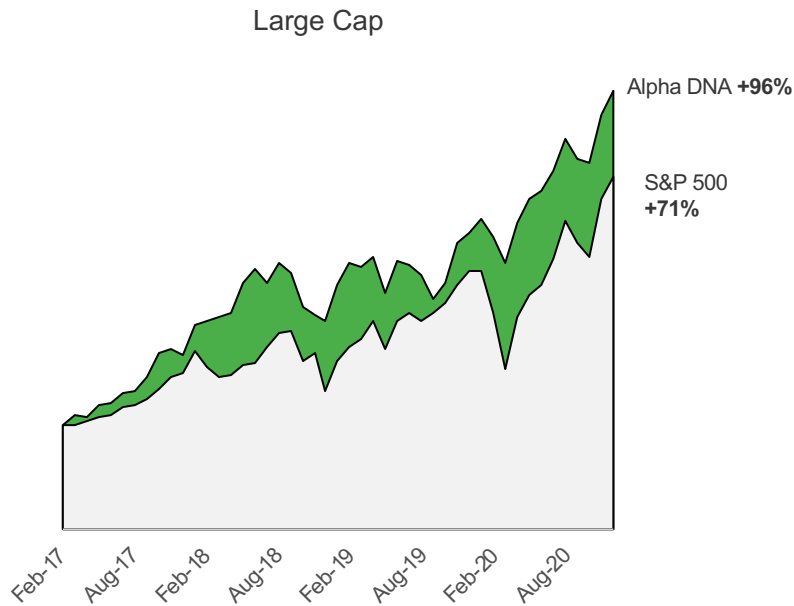
Always Hedged

- Purchase index puts on SPY & IWM
- Maintain 100% notional hedge coverage
- Hedge is typically around 3-5% of portfolio
- Always be hedged. No Market Timing

Actively Managed

- Target exposure: 70% Net Long
- Adjust options regularly
- Harvest profits from the hedge
- Rebalance equities monthly
- Make tax adjustments efficiently

Our Capture Ratio has been over as our equity performance has produced sufficient excess return to fund the cost of the hedge



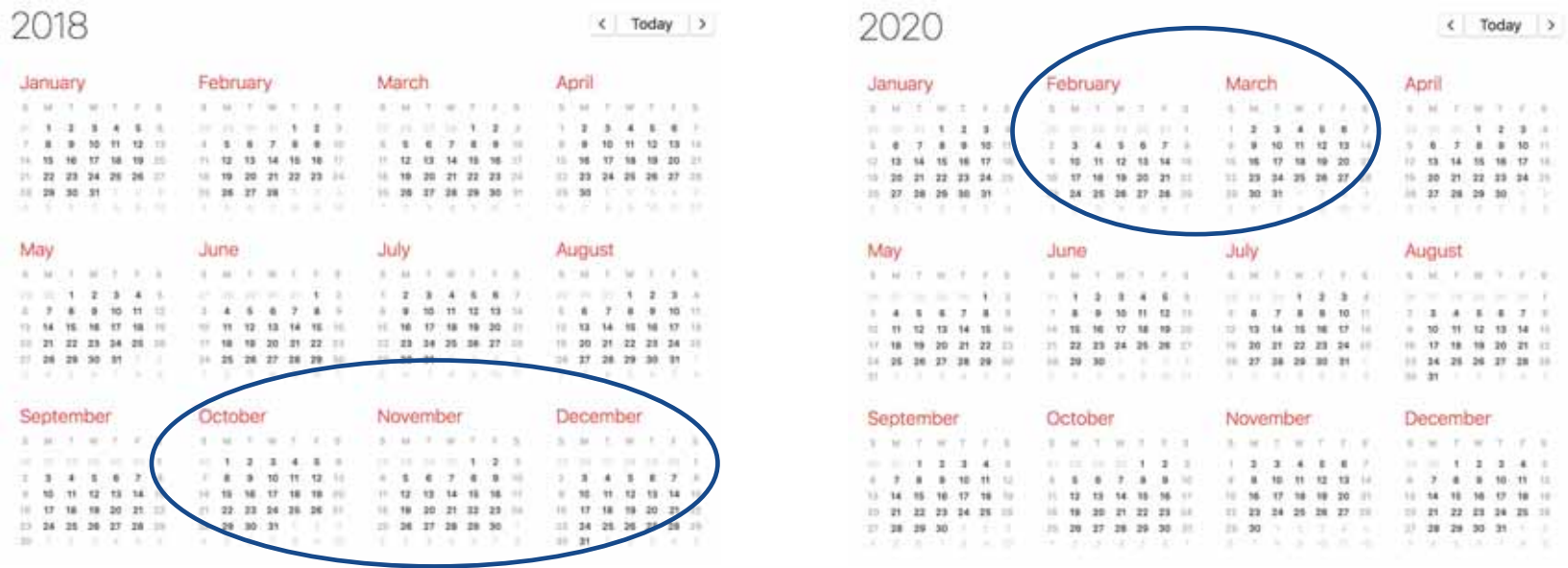
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Ask the Manager: did the strategy provide material offsets to market losses during material market declines? If not, were you even hedged?



Ask the manager for the max drawdown during each of these sell off periods

See our returns on our site (www.alphadnaim.com) to perform the Scenario Analysis yourself

Historic Returns		Return Statistics			Quantitative Statistics				2017-03		to		2021-04	
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	
2021	2.96%	1.71%	-0.65%	3.30%	-	-	-	-	-	-	-	-	7.47%	
2020	2.50%	-3.27%	-4.67%	7.51%	4.53%	1.55%	3.13%	5.36%	-2.92%	-0.82%	7.79%	3.80%	26.26%	
2019	8.29%	4.41%	-1.01%	2.16%	-7.15%	7.08%	-0.79%	-2.00%	-5.10%	3.35%	8.44%	1.87%	19.75%	
2018	7.19%	0.92%	1.25%	0.79%	6.52%	2.82%	-2.88%	4.13%	-1.79%	-6.92%	-1.86%	-1.40%	8.16%	
2017	-	-	3.02%	-0.81%	3.47%	0.85%	2.71%	0.60%	3.61%	5.99%	1.08%	-1.84%	20.05%	

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Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2021	7.70%	4.69%	1.60%	6.04%	-	-	-	-	-	-	-	-	21.47%
2020	2.28%	-3.81%	-7.77%	12.59%	8.49%	3.80%	5.52%	1.79%	-4.16%	-0.57%	8.99%	5.61%	35.54%
2019	8.91%	7.00%	-1.85%	-0.08%	-2.52%	6.84%	5.83%	-1.31%	-4.01%	-0.16%	5.72%	1.65%	28.03%
2018	6.38%	-1.12%	6.81%	-0.25%	7.99%	0.28%	-1.66%	10.85%	-2.00%	-4.88%	-0.90%	-0.52%	21.58%

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As Separately
Managed
Accounts

1. Alpha DNA Large Cap Hedged Equity
2. Alpha DNA Mid-Small Cap Hedged Equity
3. Alpha DNA All Cap Hedged Equity

As an
Exchange
Traded Fund





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