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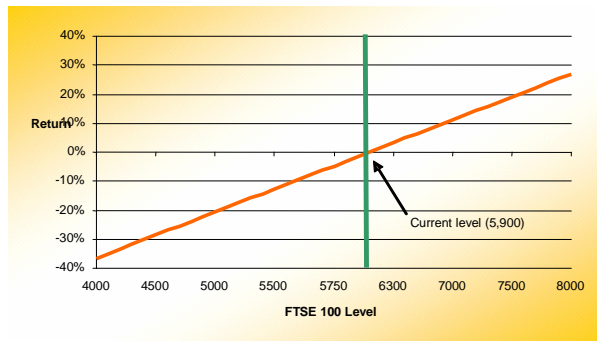
Equity Update 08- Flying with the Condor

Review of 2007

In early 2007, in a paper entitled "Shaping Equity Returns" P-Solve presented its views on the equity markets and the general global economy. We argued that for a number of reasons, (increasing interest rates, higher inflation, historical performance and the length of the bull market) we were concerned with potential equity market returns. As we can see in the table below, over 2007 the major world indices have not reproduced the large double digit returns of previous years.

	S&P500	FTSE100	EUROSTOXX 50	NIKKEI 225
02/01/2007	1416.6	6310.09	4182.12	17353.67
02/01/2008	1447.16	6416.7	4339.23	14691.41
% Change	2.16%	1.68%	3.76%	-15.34%

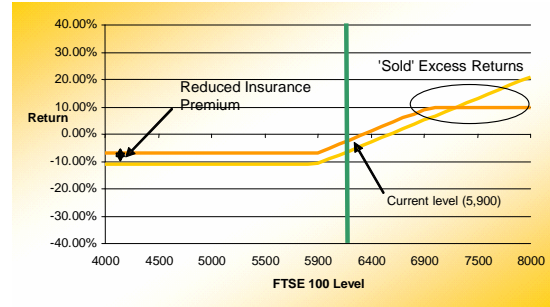
Our conclusion from this paper was that trustees should consider carefully their current equity allocation and potentially consider a better way of accessing equities. This was introduced as the idea of shaped equity returns.



The above graph shows an un-shaped position: if the markets rise you make money and if they fall you lose. But perhaps this isn't the payoff line you want to be on when equity markets move.

If not, the first and most obvious step in shaping your equity exposure would be to avoid the large losses experienced when equities fall in a bear market.

A payoff profile with no downside provides the perfect return for trustees i.e. it provides all of the upside of equities whilst removing the chance of losing. In reality, this return profile is only achievable by purchasing insurance which costs money. Therefore, when taking into account the cost of this insurance, the overall return from equities is reduced by the insurance premium as shown by the yellow line in the graph below.



The cost of this 'insurance premium' can be reduced by selling some of the upside as depicted by the orange line in the graph above. The idea of buying insurance to protect against poor returns, and paying for this by selling returns that are not absolutely required, is the essence of shaping equity returns. There are many ways of achieving this, allowing the returns to be shaped to your specific risk/return requirements.

Shaped Equity implementation in 2007

Over the course of 2007 P-Solve implemented a number of shaped equity solutions for clients. In this section we review the most popular structure (a Geared Call Spread on a World Basket) and examine how the pricing of this type of shaped equity changed over the course of 2007. To re-cap, gearing provides additional exposure to the equity market, a 100% gearing tracks the equity market 1:1 whereas 150% gearing implies that a 1% rise in the market will result in a return of 1.5%.

Example Geared Call Spread Parameters

Parameters	
Investment period	3 Years
Underlying	World Basket Price Index
Performance Target	Cash+4%
Return Gearing	168%
Index Target	119%
Maximum Loss	0%
Participation above Target	50%

This solution provides capital protected equity returns. The structure achieves its targeted return of Cash+4% annualised if the Basket Price Index moves up to 119% of its initial level over the three year term. If the Index stays unchanged, or ends up lower than its initial level, the strategy will deliver an approximate return of 0% per annum. In designing the solution we have allowed for a downside of 0% per annum as the maximum tolerance level that the Trustees are willing to accept before any protection will activate.



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Impact of Changing Market Conditions

To illustrate how the change in option pricing (caused by changes in expected volatility, dividends and interest rates) has affected the potential equity strategy we will look at how the equity strategies executed have progressively got worse as implied volatility has risen. In early June we executed a Geared Call Spread for a client achieving gearing of 200%, by mid August the gearing had dropped to 168% by early October the gearing had slipped further to 145%. The last Geared Call Spread we implemented in mid November was done at a gearing of 128%. Since then implied volatility has risen further and hence the pricing for the Geared Call Spread strategy has continued to deteriorate. By December the Geared Call spread structure previously preferred by trustees would have a gearing of only 100%, and, to achieve a return of Cash+4%, the equity markets price indices would have to rise to 130% of its starting level over the next 3 years, compared to only 116% in June.

At this point the cost of buying insurance is expensive! Increased worries about global growth and the Sub prime crisis means more people are trying to buy insurance and hence the price has gone up.

So Has the Horse Bolted?



The graph above shows that the FTSE100 Price Index has fallen quite hard from its highs of 6732 back in June 2007 to its value at the time of writing of below 6000, a fall of approximately 12%. Does this mean that the time to shape equity returns has gone?

It is important to remember that the equity market is still over 100% of the level 5 years ago and hence exposure on the downside is a very real risk. Accordingly it is still appropriate to consider protection against the risk of further equity market falls. However, we believe that the popular 'Geared Call Spread' strategies (and the more cautious 'Cap and Collar' strategies) are no longer appropriate in the current volatile environment.

A shaped equity return strategy would therefore need to:

- take advantage of the current pricing conditions for shaping equity returns,
- whilst still protecting against further downside exposure, and
- allowing for outperformance should the market recover.

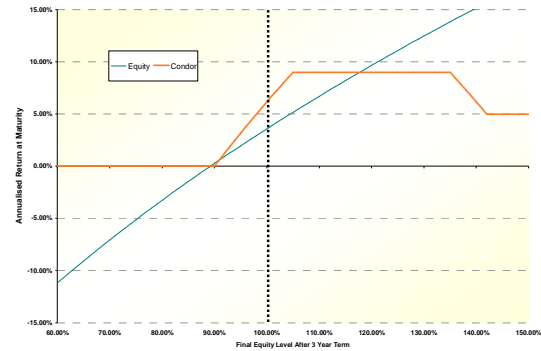
To this end we would currently recommend the 'Condor' strategy detailed in the table below.

Parameters	
Investment period	3 Years
Underlying	FTSE100 Price Index
Performance Target	Cash+4%
Return Gearing	190%
Index Target	Between 105% and 135%
Return above Target	Cash

Payoff Profile for the Condor

The payoff profile graph below compares the return on the Condor against equity price index returns for different levels of the market at the end of the three year term. The graph shows that the Condor provides better than equity returns for market levels below 117.5%.

Between this level and 135% the Condor will provide a stable return (targeted as Cash + 4% p.a.). After a market level of 135% the return will fall until the market achieves 142% at which point the Condor will produce a stable cash return



The beauty of this strategy is that whilst it benefits from the volatile markets that we are seeing at the moment, it also outperforms if the market rallies back to its highs (ie rises 10-15%). We will have benefitted from increased exposure to the market and thus will have achieved a higher return than just our investment in equities alone; we will be better off than if the market had stayed at its recent highs

Summary

We believe that the equity markets are still very fragile and will continue to be volatile. Shaping equity returns and introducing downside protection in the form of a Condor is a valuable addition to the equity component of an investment strategy as it provides:

- Downside protection,
- Enhanced recovery if the market rallies to its recent high (ie back to 6732)
- Opportunity to benefit from a fall in volatility.

These benefits are achieved by:

- Capping the scheme's ability to participate in equity returns of more than cash+4% per annum, and, the risk that if the market rises above 142% only achieving a cash return. This risk can be managed through early restructure or termination.
- Accepting short term mark to market losses (that will revert to zero cost on expiry) if volatility continues to increase

In addition, a Condor works well sitting alongside an unhedged equity exposure since the Condor will protect the downside return and provide a good return in a sideways or directionless market, whilst the unhedged equity portfolio will produce good returns in a strongly performing market.

If the equity markets continue to fall further over the next few weeks then the motivation for this strategy becomes even stronger.

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