

The Equity Market is dead. Long live the Equity Market!



We are in the throes of a recession and equity market levels are reflecting the turbulence experienced in the last 18 months. Ironically, these market levels mean that the decision to be in equity markets is easier than it has been in the past but is there a better way to access future returns?

Introduction

It has been a tough 12 months for equity markets. The main indices are down between 30% and 50% initially driven by the financial crisis and more recently by recession concerns.

This has obviously had a huge impact on pension schemes and their funding positions. But this is not a unique event – pension schemes are long term investors and have always tended to shrug off the down times in anticipation of the good times that follow.

This note reconsiders what pension schemes are trying to achieve with equity exposure and then discusses how equity options may help.

What are equities for?

Most pension schemes require some outperformance from their assets and equities have always played a central role in this. However, it is often difficult, after a period of poor returns, to understand the motivation for being in equities but equity exposure will inevitably play a part in a diversified return generating strategy.

So does that mean for pension scheme investors who are already in equities it is a case of “riding the storm”? For investors who have been fortunate enough to be out of the market for the last 12 months, is now the right time to be getting back into the market?

For either investor, the question of whether to be in equities or not is undoubtedly an easier one to answer at the current levels than it was 12 months ago.

Buying into the equity market in a traditional way means a scheme is exposed on a 1-for-1 basis to the market – so for a rise in markets of 10% you make 10% and for falls of 10% you lose 10%. Therefore, to recover from the current position, equity markets need to recover at least 65% before the scheme breaks even and recovers the 40% losses made

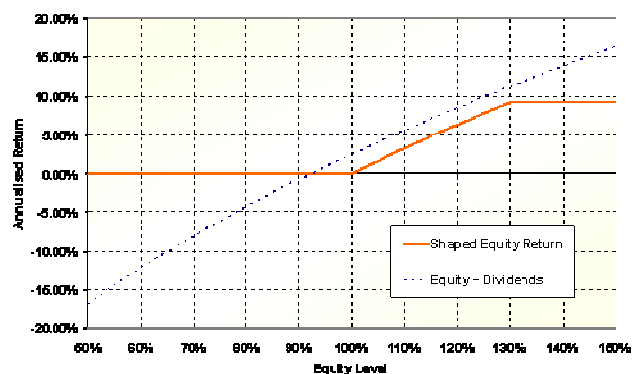
in the last 12 months. We would propose that a more suitable equity exposure at the current time is one with enhanced participation if the equity market rallies and some downside protection to provide some risk reduction.

This paper follows on from our previous papers on “Shaping Equity Returns” and discusses how Equity Options can be used to access the equity market in a more efficient way at current levels.

Shaping Equity Returns – Recap

Equity options are derivatives whose payoffs are linked to equity market returns. They can be used to protect downside equity exposure and/or to enhance participation in equity market rises.

Downside protection costs a lot of money especially in freefalling markets and so in previous papers we have shown how downside protection can be purchased by selling some of the extreme upside returns as shown below in the payoff graph of the Geared Call Spread:



Our previous notes on shaping equity returns have focussed more on how to protect downside exposure and also how to access a return in sideways markets.

Most investment managers and advisors will correctly highlight that current market pricing makes for very unattractive traditional protection strategies at the moment due to the recent heavy falls in world equity markets. The team at P-Solve has many years of experience in structuring and trading derivatives for various Investment Banks and as a result has identified strategies that benefit from these

adverse market conditions whilst still providing the downside protection that is required against further falls – one of these strategies is the “Enhanced Call Spread”

Enhanced Call Spread

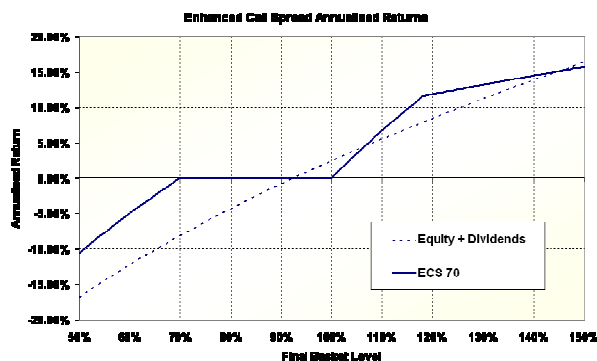
The Enhanced Call Spread (ECS) is a particular strategy that we have implemented for a number of clients recently at very favourable levels. The basics of this strategy are that it provides protection against some falls in the equity markets from current levels whilst also allowing the scheme to participate at a geared rate to any increase in equity market levels. For example if the gearing was 200% then if the FTSE100 index rises 10% over the life of the structure then the scheme will receive a return on maturity of 20%. The key attributes of the ECS are discussed below

- Geared equity exposure aiming to achieve a Cash + 8% p.a. return as soon as possible
- 50% participation in equity market rallies above the target level of Cash + 8% p.a. to enable the scheme to access, at least partially, the impact of a strong bull run.
- Some downside protection for falls in equity markets of up to 30% (based on current option pricing)
- The maximum loss on this structure will be 100% of capital invested; this will occur if the underlying equity index falls to zero.
- However, for equity market falls, the structure will have a value higher than an equivalent equity investment (excluding dividends)
- The term of the options will be up to three years although earlier liquidation would be possible if required.

These parameter targets are summarised in the table below.

Parameter	Target
Term	3 Years
Performance Target	Cash + 8% p.a.
Index	FTSE 100
Maximum absolute downside form Strategy	100% loss of capital
Gearing on outperformance	Current markets indicate 200%
Index return required to hit outperformance target	Current markets indicate 20%
Participation above Targeted outperformance level	50%
Exposure to Downside commences at	70%

The graph below illustrates the return of the ECS at maturity for different changes in the equity market over the life of the structure.



Implementation of an ECS will allow the Trustee to benefit in any possible bounce in the market from the current levels. In addition, an ECS can offer greater exposure to the upside whilst still offering initial protection for falls of up to 30% (on maturity of the product) in the markets.

However, there are scenarios where this strategy will not be attractive and as the market is constantly moving, this needs to be closely monitored. For example, if we were to see another temporary market bounce then this may not be a good time to implement such a strategy. This is because falling more than 30% from this level would be more likely. Also, if market conditions change significantly it may not be possible to achieve the same level of gearing. For these reasons, and if the Trustee decides to implement an ECS, we would propose putting in place implementation triggers to ensure that the implementation level and gearing remains favourable.

Summary

Equity markets have suffered significant falls from their highs in 2007. However, it is the future potential outperformance of equity markets that makes them attractive to pension schemes. Given this, entry into the market at current levels is more attractive and equity options may be a more effective way to access this performance. The Enhanced Call Spread provides geared upside return to take advantage of any rally and also some downside protection.

Where can I get further information?

For further information, or to discuss the possibility of a training session on any of the areas discussed, please contact the P-Solve RMS team at RMS@psolve.com or your usual P-Solve client relationship manager. Please also visit our website at www.rms.psolve.com where you can find further information on our products including education and research documents, as well as some tools that can be used to explore different derivative strategies.