Kendrick Wakeman, CFA
kwakeman@badonhill.com
203-542-0588

COUNTERMEASURES FOR A MUTED EQUITY OUTLOOK

Bill Gross, CEO of PIMCO, recently put forth a fairly dim view of equities in his August investment letter (link).[i] His view is shared by many: we should expect much lower returns from the equity market going forward. Although he does not lock himself into a number, he seems to be suggesting expected returns in-line with GDP growth or perhaps something in the inflation plus 0.5-1.0% range. Either way, it appears that he is looking for equity returns to be sub-5% in the intermediate to long term, higher only in the case of high inflation.

If true, this poses a practical question for those investors who are unwilling or, unfortunately, unable to accept such low returns from their portfolio, namely "how can you increase returns in a moderate equity market?" Seemingly in response, PIMCO published another paper, "Equity Implications for a Modest-Return World" by Andrew Pyne (link).[ii] It suggests four ways investors may increase their expected equity return:

1. Invest in high dividend stocks
2. Switch from passive to active management
3. Seek out companies that have exposure to high-growth economies
4. Hedge against downside risk/tail events

The first three are fairly well covered in the PIMCO report so there is no need to re-cover them here. The fourth seems more about decreasing risk instead of increasing return, so we will set that aside as well (but interested investors can read our presentation "Protecting Equity Portfolios: the Need and the Solution").[iii] Instead, we would like to add a few less conventional methods of increasing return. Not all investors can avail themselves of these strategies, but for appropriate investors, we feel there are potentially meaningful benefits in a "moderate return world":

1. Make Equity Long/Short part of your equity allocation
2. Shift allocation from Equities into Absolute Return strategies
3. Write covered calls against your equity positions

Scenario	Average S&P 500 Return	Average CBOE S&P500 Buy-Write Return	Average HFRI Relative Value Return	Average HFRI Equity Hedge Return
In a Moderate Equity Return Environment	5.08%	8.35%	10.08%	11.96%

Source: www.hedgefundresearch.com, CBOE, internal calculations

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Equity Long/Short

Traditionally, investors look at Equity L/S as a way to play the equity market with reduced volatility. This is because the short positions in the portfolio help cushion the losses from the long positions if the market declines. On the other hand, the short positions also curtail the gains on the long positions if the market rises. The net effect is reduced volatility, hopefully coupled with increased alpha if the long positions outperform the short positions.

However, if an investor selects the correct managers, Equity L/S can also serve to boost returns in a modestly rising/falling market. This is because a skilled manager may be able to produce profits on both a long and a short basis as long as the market does not move too far in any one direction. Should the market rise or fall significantly, Equity L/S will most likely lag as the manager is apt to lose money on either the long or short positions. However, under the muted equity market thesis this is a low probability contingency.

In order to ascertain if this has been the case historically, we looked at all the 12-month rolling periods from 1990 to the present using the HFRI Equity Hedge (Total) Index as a proxy for Equity Long/Short. If we isolate those periods where the S&P 500 returned between 2.50-7.00% (an average of approximately 5%), we find that the average return for the HFRI Equity Hedge Index was 11.50%. If we lower our return range to only include periods where the S&P 500 returned between 0.00-5.00%, the return drops to 9.49%, which is still well in excess of the 3.27% average performance for the S&P. In both instances, we saw a meaningful outperformance from Equity L/S funds on average.

To rule out the possibility that the increased performance was due to the fact that many Equity L/S funds use leverage, we examined a moderately down scenario (flat to down 5%). Once again, the HFRI Equity Hedge Index outperformed, returning +3.79% vs. an average loss of 1.72% for the S&P 500. This suggests that leverage is not a meaningful factor.

Rolling 12-Month S&P Return Filter	Average S&P 500 Return	Average HFRI Equity Hedge Return
2.50%-7.00%	5.08%	11.96%
0.00%-5.00%	3.27%	9.49%
(5.00%)-0.00%	(1.72%)	3.79%

Source: www.hedgefundresearch.com, internal calculations

If PIMCO is correct, shifting part of your equity allocation to Equity L/S may help you outperform. However, we caution investors that Equity L/S is generally fairly highly correlated to the stock market. If there were to be a moderate to severe market decline, we would expect Equity L/S to produce negative returns, albeit not as negative as the stock market. Therefore, we encourage investors to think about Equity L/S as part of their equity allocation, not as a way to diversify away from equities. For investors that are looking to diversify away from equities and still maintain a high expected return, we might recommend no/low correlation strategies such as Relative Value Arbitrage or Global Macro. Recent changes in institutional allocation frameworks seem to reinforce this concept (see our paper "Shift in Institutional Allocation Framework May Have Large Implications for Hedge Funds").[iv]

Relative Value Arbitrage

Relative Value Arbitrage is a collection of strategies that seek to make money equally under any market condition by profiting from the difference in performance between two closely related investments. For example, a Relative Value manager might buy the bond of a company and sell short a different bond on the same company, or a substantially similar company. Although both instruments will likely move in a coordinated and offsetting way, there may be some identifiable and predictable anomaly that that might cause one bond to outperform the other. Importantly, this strategy typically does not rely on any movement in the overall market, just a relative movement between the two or more items being traded.

Since Relative Value Arbitrage does not rely on the movement of the stock market to produce returns, we would expect a fairly stable return regardless of market conditions. As long as the absolute level of return is acceptable, these strategies could be attractive for an investor who is looking to outperform in a lackluster market and/or is looking to diversify away from equity risk. If the potential for a large market decline or tail event is a reasonable possibility in the eyes of the investor, Relative Value strategies may help to alleviate some of that perceived risk.

However, investors should keep in mind that the relatively stable return profile also means that these strategies will likely underperform in a rapidly rising market. Unlike allocating to Equity L/S, allocating from Equity to Relative Value Arbitrage involves making a conscious decision to lower your equity exposure. In the case of a muted equity outlook, this may not be a problem, but investors need to be prepared to underperform both equities and Equity L/S in a strong bull market. As an aside, Relative Value Arbitrage may, in some cases, function as a surrogate for fixed income, which PIMCO also believes to have low return prospects.

To illustrate how Relative Value Arbitrage compares to Equity L/S, we calculated the same performance data as before. As you can see, the variation of returns is small relative to Equity L/S. Much like Equity L/S, Relative Value has also historically outperformed equities in a lackluster return environment.

Rolling 12-Month S&P Return Filter	Average S&P 500 Return	Average HFRI Relative Value Return	Average HFRI Equity Hedge Return
40%+	47.87%	21.38%	28.20%
20%+	28.57%	14.06%	24.39%
2.50%-7.00%	**5.08%**	**10.08%**	**11.96%**
0.00%-5.00%	**3.27%**	**9.64%**	**9.49%**
(5.00%)-0.00%	**(1.72%)**	**7.41%**	**3.79%**
<(5.00%)	(19.94%)	2.28%	(4.89%)
<(40%)	(42.42%)	(15.00%)	(25.21%)

Source: www.hedgefundresearch.com, internal calculations

We have expanded our scenarios to include some periods of extreme market movements to help illustrate the benefits and drawbacks of both Equity L/S and Relative Value. As we may have anticipated, both Equity L/S and Relative Value lag the stock market both to the upside and to the downside. Also as anticipated, the Relative Value return stream has been more stable than Equity L/S, giving it better performance to the downside at the expense of some upside participation.

From the standpoint of allocation, we would predict that investors who place a higher probability on a market decline will tend to favor Relative Value while investors who feel otherwise will favor Equity L/S. If one truly believes in the muted equity scenario, it may be advisable to do both.

Writing Covered Calls

Writing covered calls, a strategy known as "Buy/Write," is a way for investors to sell away some of the potential upside of their stocks. In return for limiting their upside, investors are rewarded with increased current income. If properly executed, this can turn a lackluster equity return into something more palatable. The obvious drawback is that, should the stock rally substantially, the investor may have to sell their position at only a modest gain and forego a significant profit. For this reason, the strategy fell out of favor during the heady days of the bull market. However, given the increased outlook for muted equity gains, coupled with continued high volatility, we believe this strategy is ripe for a resurgence.

Ideally, investors employ this strategy at the position level. This is to say that investors should look at the individual stocks that they own and consider the appropriate amount of upside to sell away on each stock on a case-by-case basis. In reality, this can be overly labor intensive so investors are left to either hire a manager/consultant to perform the analysis and effect the trades on their behalf, use index options to sell away some of the generic upside in their portfolios, or invest in one of the many funds that engage in buy-write strategies.

The CBOE has created several indexes to track the performance of a hypothetical Buy/Write strategy. We will look at one such strategy, the BXY, which tracks a passive strategy of systematically buying the S&P 500 and selling 2% out of the money calls. In exchange for passing up any monthly price appreciation above 2% (roughly 27% annualized), the investor is rewarded with increased income. This income provides a small cushion to the downside, but more importantly, can potentially shift the performance in a lackluster market from "inadequate" to "acceptable."

Rolling 12-Month S&P Return Filter	Average S&P 500 Return	Average CBOE S&P500 Buy-Write Return	Average HFRI Relative Value Return	Average HFRI Equity Hedge Return
40%+	47.87%	30.97%	21.38%	28.20%
20%+	28.57%	22.34%	14.06%	24.39%
2.50%-7.00%	**5.08%**	**8.35%**	**10.08%**	**11.96%**
0.00%-5.00%	**3.27%**	**7.79%**	**9.64%**	**9.49%**
(5.00%)-0.00%	**(1.72%)**	**3.75%**	**7.41%**	**3.79%**
<(5.00%)	(19.94%)	(9.59%)	2.28%	(4.89%)
<(40%)	(42.42%)	(29.71%)	(15.00%)	(25.21%)

Source: www.hedgefundresearch.com, CBOE, internal calculations

As we can see from the above table, selling covered calls raises returns in our target scenario to the more acceptable 8% range. In a low return environment, this may be considered a significant improvement. The extra income does provide a bit of cushion to the downside, but the strategy will still suffer in a major decline.

Overall, the historical return data do not initially look as attractive as Relative Value or Equity L/S in many of our scenarios, including our target scenarios. However, there are some important factors to consider which may make the strategy more attractive:

1. Highly Accessible. Any option-qualified investor can write call options against their stock holdings or hire a manager to do so. Investors who are not option-qualified can invest in several listed funds that engage in buy-write strategies. In comparison, Relative Value and Equity L/S products are typically only available to high net worth individuals and institutions, although that is starting to change somewhat with listed alternative products.

2. Highly Liquid. Liquidity is typically daily, if not intra-day, allowing for investors to reposition quickly should their outlook or needs change. This can be an important consideration in volatile markets, particularly for individual investors, who tend to have shorter investment horizons and higher liquidity needs than institutions. By contrast, Relative Value and Equity L/S are typically in limited partnership formats with restrictions on redemptions.

3. Potential Gains from Active Management. The buy-write returns we have analyzed are passive by nature. As with all investment strategies, switching to active management provides for possible improved results. In the case of a buy-write strategy, active management can consist of writing options on individual stocks instead of indexes or employing some sort of timing/selection strategy that seeks to improve returns through quantitative, technical or fundamental means. By contrast, the Relative Value and Equity L/S data already reflect active management.

Conclusion

To the extent that investors believe in the muted equity thesis, we would strongly advise them to take the time to position their portfolios appropriately. Our observation is that most portfolios are currently not well positioned for what increasingly appears to be the consensus for equity returns going forward. This is to say that many portfolios are largely positioned for strong equity gains, possibly with an oversized cash position as an ad-hoc tactical safeguard against a market decline. In a low return environment, adding as little as 2% to returns can be a meaningful improvement. In the case of pension funds, this might make the difference between meeting your required rate of return and failing to do so. If investors feel strongly enough in this thesis and it is appropriate for their portfolio, there is nothing that necessarily prevents them from deploying all three strategies simultaneously.

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[i] William H. Gross, "Cult Figures" *PIMCO Investment Outlook,* AUG 2012.
http://www.pimco.com/EN/Insights/Pages/Cult-Figures.aspx

[ii] Andrew Pyne, "Equity Implications for a Modest-Return World" *PIMCO Viewpoint,* JUL 2012
http://www.pimco.com/EN/Insights/Pages/Equity-Implications-for-a-Modest-Return-World-July2012.aspx

[iii] Kendrick Wakeman, CFA, "Protecting Equity Portfolios: the Need and the Solution" *Badon Hill Presentation Series,* 24 SEP 2010.

[iv] Kendrick Wakeman, CFA, "Shift in Institutional Allocation Framework May Have Large Implications for Hedge Funds" *Badon Hill Alternative Markets Update Series,* 24 JUL 2012