FUND MANAGEMENT

Hedging strategy cushions investors

The sharemarket cloud has $150 million silver lining for NZ Funds

Sarah McDonald

A local funds management firm reckons it has saved investors $150 million through an equity hedging strategy that it implemented before the markets descended into chaos.

Over the last 12 months, equity investment "success" for most fund managers has been defined not by how much they have made, but how (relatively) little they have lost.

NZ Funds director Richard James said his firm's clients have been cushioned by share market protection strategies that have, the company has calculated, preserved $150 million of their capital.

NZ Funds decided in 2007 that the chance of a contagion effect from credit markets across to share markets was unacceptably high.

To mitigate the potential losses if this eventuated, it implemented strategies based on research in the area of behavioural finance, which attempts to explain why investors react in certain ways to market events.

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>
> Richard James
> Director, NZFunds

Equities, as any fund manager will argue, are higher risk than other asset classes but according to historical returns, likely to provide a better return over the long-term.

However, Mr James said the traditional models of portfolio theory fail to take investor behaviour into account.

"The traditional approach largely ignores two critical considerations. First, equity markets can underperform less risky assets for prolonged periods and second, the long term return averages mask the fact that equity markets quite often produce substantially negative short term returns.

"Very few investors can deal with periods where equity markets may fall by as much as 40%, as has occurred twice this decade," he said.

Any investor forced to sell in a downturn will not achieve the theoretically higher return from equities.

"What are required are portfolio strategies that manage volatility to enable investors to stay the course. These strategies involve both how the portfolio is structured and how it is managed," Mr James said.

NZ Funds' hedging strategies use futures and options contracts to reduce the risk of capital losses as a result of equity market underperformance.

According to behavioural finance, investors are prepared to forego gains if they are able to limit their losses.

"Since its original implementation, our hedging strategy has been extensively developed with the aim of limiting the impact of the large negative returns that occur periodically in equity markets," Mr James said.

"As the market recovers, the hedges will progressively unwind so that the portfolios will benefit from the equity market performance."

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