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Risk Mitigating Strategies: The results are in

Institutional investors who implemented risk-mitigating strategies in the wake of the global financial crisis have been waiting a long time to see how these programs would perform. The COVID-19 disruption provided a compelling test case in Q1.

By Neil Rue, CFA; Brian Dana, CAIA; Frank Benham, CFA, CAIA | July 22, 2020

Many observers have struggled to make sense of the markets amid the coronavirus pandemic. During the first quarter of 2020, concerns about the economic impact from COVID-19 and related "shelter-in-place" restrictions resulted in global equities declining by up to 34% for both the S&P 500 and MSCI ACWI. In the U.S., the sell-off required only 24 days to enter bear market territory, representing the S&P 500's fastest such decline in history. The rebound, however, has been just as swift and somewhat perplexing. The index, by July 1, had gained approximately 40% since its March trough, while the MSCI ACWI index has experienced a similar bounce.

There are a number of factors contributing to the rebound. Fiscal and monetary stimulus can't be overlooked, having infused a tremendous amount of liquidity back into the global economy. And since then, better-than-expected economic data, a flattening of the coronavirus curve, and more recently, news of a potential vaccine have all bolstered investor sentiment even as many communities remain in the early phases of lifting quarantine restrictions.

One overlooked factor, however, has been the Risk Mitigating Strategies ("RMS") put in place by many of the largest institutional investors. While these strategies differ from institution to institution—and most RMS initiatives hadn't been tested until the COVID-19 disruption—these strategies performed exactly the way

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they were designed to perform in volatile markets with debilitating losses in most traditional asset classes. Anecdotally, asset owners were not only able to emerge from the March dislocation better positioned than their peers, but many quickly took advantage of the positive returns to rebalance toward risk-oriented assets.

For the uninitiated, RMS is an asset allocation program that can provide institutional portfolios with robust diversification benefits and defensive characteristics relative to growth-oriented asset classes such as equities and credit. RMS programs are designed to have low correlations to equities and traditional assets on average. More importantly, they also have the potential to profit from turbulent environments or equity drawdowns by having low to negative conditional correlations to equities coupled with higher levels of volatility than more traditional stable assets.

RMS programs generally incorporate several of the following asset classes: Long Term Treasuries, Trend Following, Global Macro, Long Volatility, and Alternative Risk Premia. Again, these programs differ from institution to institution, as they are tailored to each investor's objectives and constraints.

Forward thinking asset owners tend to favor a portfolio approach when constructing an RMS program as no single strategy can effectively fulfill all return and risk objectives. As return objectives and risk constraints also vary, a "one size fits all" formula does not apply. From a 30,000-foot view, however, RMS programs are expected to provide defensive characteristics during times of crisis while offering positive expected returns during normal markets to counteract the opportunity costs of allocating fewer holdings to asset classes expected to generate higher returns.

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Sounds good in theory, but does it work? That's the question that faced institutional investors in late March as the reality of the COVID-19 disruption set in.

Looking at a representative sample of the RMS universe composed of more than 35 Meketa clients, the risk-mitigating portfolios performed as expected. The median RMS strategy gained 6% during the first quarter, and on average, the strategies generated 7.5% during the first three months of the year. The S&P 500, during the same period, lost 19.6%; the Bloomberg Barclays Aggregate, a proxy for core investment-grade bond allocations, only gained 3.1%; and a 60%/40% stock and bond mix lost 10.9% during the quarter.

To be sure, many investors use active management to take advantage of mispricing opportunities. Most active managers of core bond portfolios, for instance, are willing to accept greater credit risk in pursuit of a higher yield. In addition, at the beginning of the first quarter, many core bond managers also had a shorter duration posture than the benchmark. Unsurprisingly, the average core fixed income fund gained just 2.0%, gross of fees in the first quarter, according to eVestment Alliance (as of 6/1/20).

Even within the RMS universe, program design and class construction will have an impact. To wit, those favoring long-duration US Treasuries or long-volatility strategies tended to outperform in Q1, whereas institutions

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favoring alternative risk premia and discretionary global macro didn't fare as well. Looking at the full range of performance by quartile shows that even within the RMS universe, outliers were evident above and below the median, with the differences in returns ranging by more than 20%.

While the quarterly performance validates the effectiveness of RMS programs to preserve assets, the upshot is that risk-mitigating strategies also support longer-term performance. Indeed, RMS programs are intended to maintain purchasing power to provide benefits for a full market cycle, not just episodic benefits when cycles turn.

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When the most recent bull market became the longest-ever upcycle in modern history in August 2018, many investors may have been second-guessing defensive strategies, particularly when the S&P 500 reached an all-time high this past February. And the old adage about trying to time the market remains as true today as ever before. But through mitigating risk, institutional investors weren't merely protecting against the downside; they were positioned to pounce and go on the offensive when the opportunity to do so presented itself this past March and into April.

This is one of the reasons, among others, that this most recent "black swan" event seems so much different than the global financial crisis. Because without even knowing what would trigger the downturn, institutional investors that had implemented RMS programs were far better prepared for the unknown this time around.

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The description herein of RMS and the targeted characteristics of this strategy and investments is based on current expectations and should not be considered definitive or a guarantee that the approaches, strategies, and investment portfolio will, in fact, possess these characteristics. In addition, the description herein of a Meketa risk management strategy is based on current expectations and should not be considered definitive or a guarantee that such strategy will reduce all risk. These descriptions are based on information available as of the date of preparation of this document, and the description may change over time. The RMS strategy is unique for each client and there is no guarantee that the strategy will benefit any client account. Past performance of these strategies is not necessarily indicative of future results. There is the possibility of loss and all investment involves risk including the loss of principal.

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