LGPS **INTELLIGENCE**

The right time for equity protection

Following our series on **equity protection**,[1] we look at the current market conditions and investigate whether it is still an opportune time to implement protection against potential falls in equity markets while still enjoying exposure to future gains.

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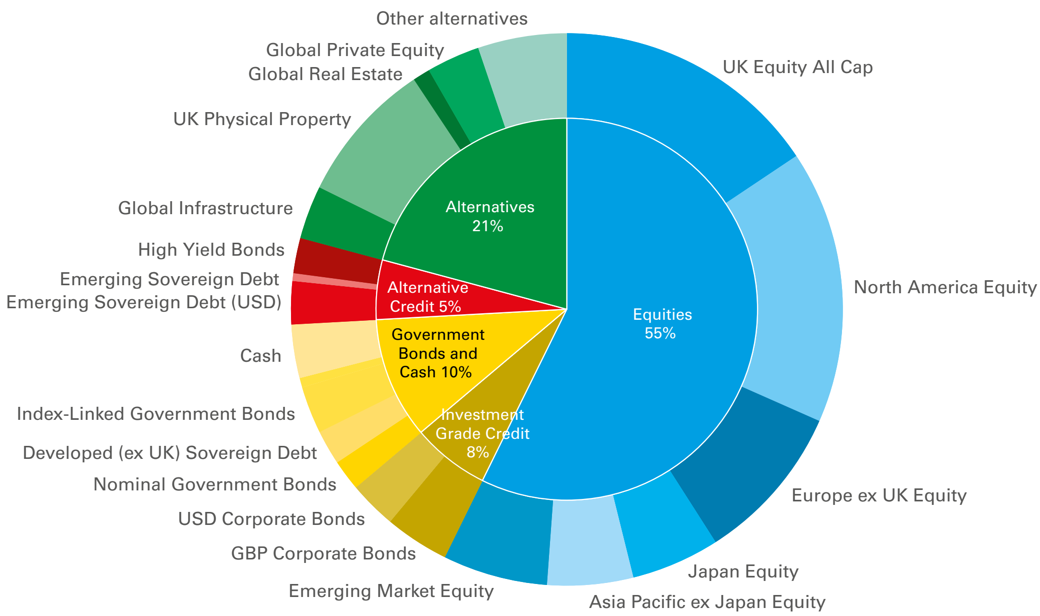
BACKGROUND

The Local Government Pension Scheme (LGPS) remains significantly invested in equities (Figure 1) in the expectation of high future returns to contribute to the funding of future benefits. However, this means that LGPS assets and therefore employer contributions are susceptible to a downturn in equities.

Figure 1: The LGPS retains a significant equity investment



Source: PIRC annual review 2018 and LGIM

1 Further to our previous article 'Better shaped equity outcomes'

Legal & General INVESTMENT MANAGEMENT

This susceptibility to equity downturns, alongside the historically cheap terms on which it has been possible to implement such protection, explains why we have seen a huge demand for equity protection solutions over the last two years from LGPS fund and corporate pension scheme clients. These have typically been implemented quickly in an easy to govern way.

A number of our LGPS fund clients who have not yet implemented these strategies ask whether they have missed the opportunity. Hence we revisit the all-important question: is now a good time for equity protection?

Please note that a recap on equity protection and how it can be funded can be found at the end of this article.

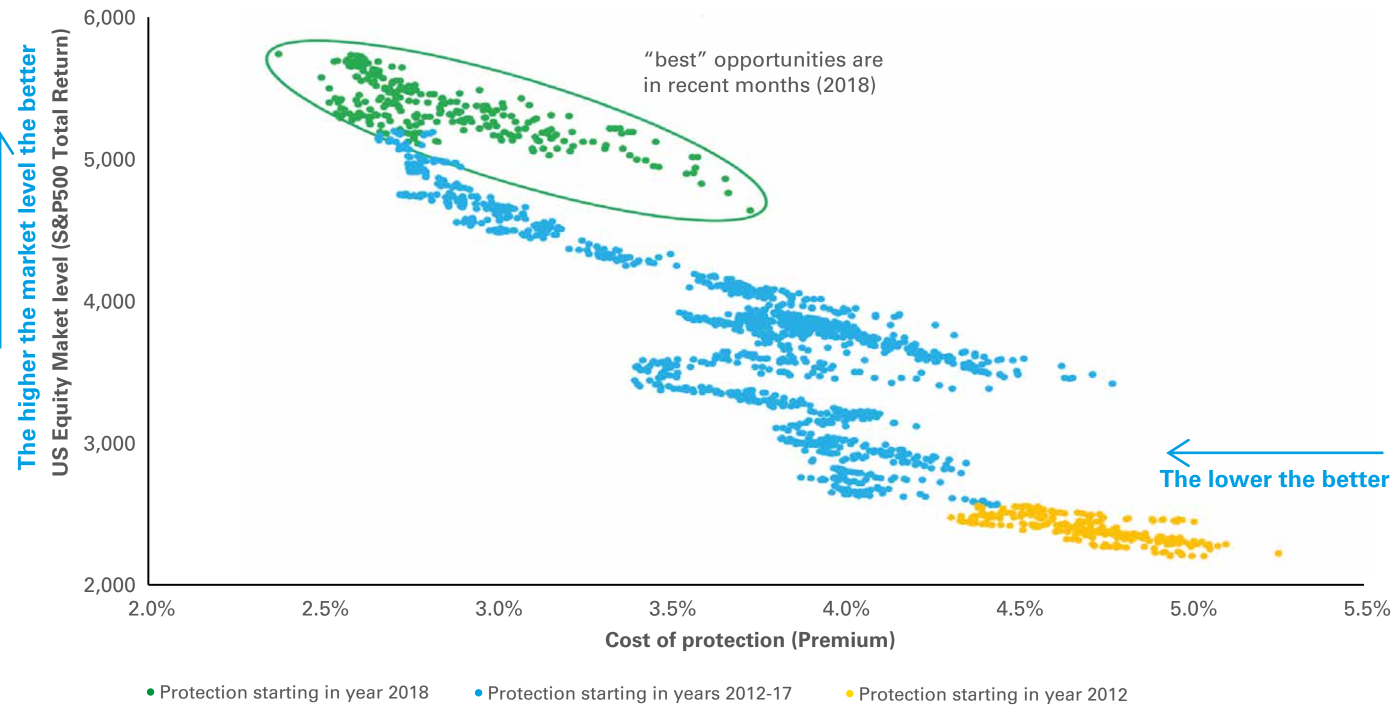
CURRENT MARKET OPPORTUNITIES

The answer to that question can depend on how the protection is paid for. For example, if we are writing a cheque, we would just need insurance to be cheap. However, if we are selling away potential return gains to buy downside protection, we need the value of what we are selling to be relatively high and what we are buying to be relatively low in comparison. Hence it is important when assessing opportunities to allow for how accessing the opportunity is to be funded. Taking each funding approach in turn:

1. WRITING A CHEQUE

The chart below plots equity market levels versus the cost of equity protection as a percentage of equity value. Each dot represents the data point for a given month. The 'best' opportunities are those dots appearing in the top left hand corner of the chart i.e. investors will typically have benefited from higher equity market levels (towards the top) and the cost of locking in those gains will be relatively cheap (towards the left).

Figure 2: Over 2018, higher market levels coincided with lower equity protection costs



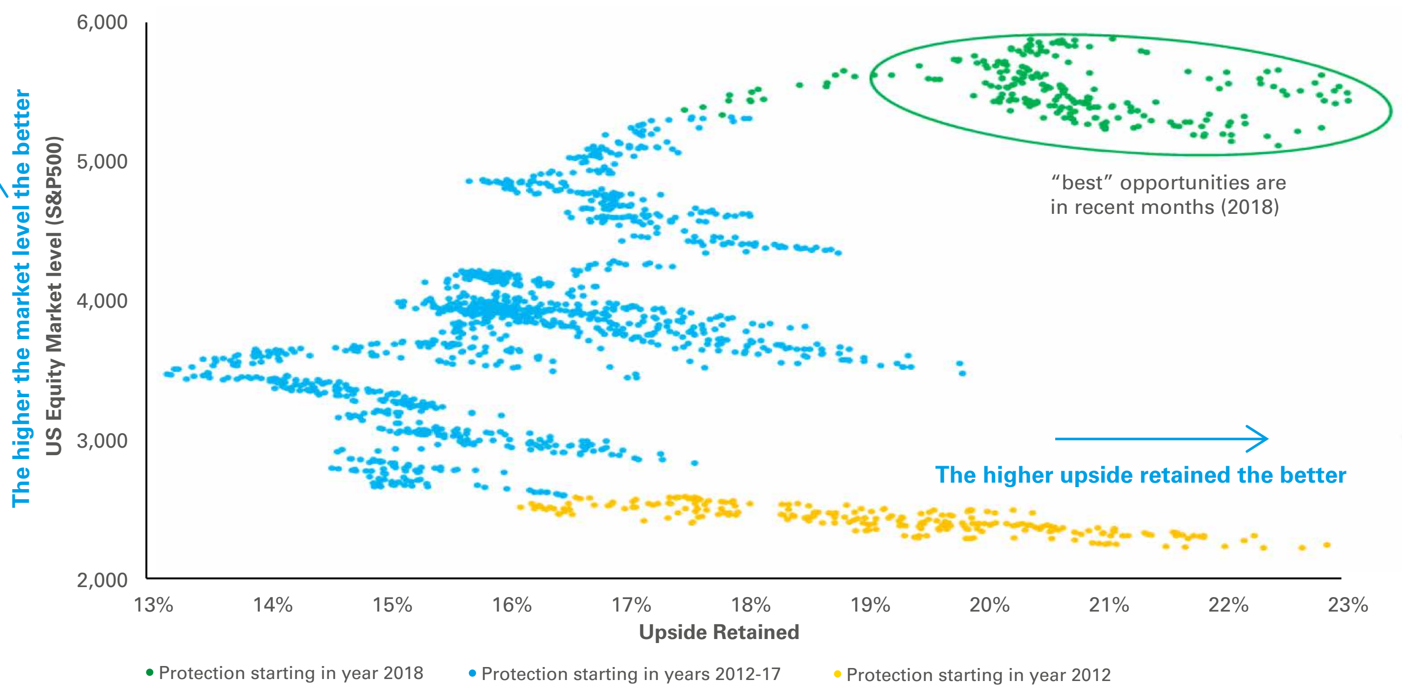
Source: LGIM analytics. Cost of protect against falls in equities of between 10% and 30% over the next 2 years

Looked at through this lens, the fact that the green dots are to the left highlight that 2018 looked like a good time to write a cheque, but the yellow dots being mostly to the right shows that the case was less compelling in 2012, when the cost of protection was relatively higher.

2. SELLING AWAY UPSIDE RETURNS TO BUY DOWNSIDE PROTECTION

The following chart again shows the equity market level, but the horizontal axis now shows the level of potential upside retained. Through this lens, 'best' opportunities are highlighted by dots appearing in the top right hand corner of the chart i.e. investors will typically have benefited from higher equity market levels (towards the top) and also are able to retain relatively more future equity upside (further to the right).

Figure 2: Over 2018, higher market levels coincided with retention of more future returns



Source: LGIM analytics. Cost of protect against falls in equities of between 10% and 30% over the next 2 years

Using this method, one can make a compelling case that more recent times have been more opportune to implement a protection strategy funded by selling away rights to future equity upside

To spot an opportunity to implement an equity protection strategy it is best to be mindful of how the protection is paid for. An opportunity to write a cheque may or may not be an opportunity to sell away upside and vice versa.

It appears that the case for equity protection has been more compelling recently (such as in 2018) viewed via either lens, as opposed to 2012 when it very much depended on how that purchase was funded. And with the developed equity market now just over 7.5% higher since the end of 2018 (to the end of March 2019) and having exhibited some volatility over that period, the demand for equity protection and the opportunity to efficiently implement it appear to have extended into 2019.

IN SUMMARY

We have been working with LGPS funds and other clients for a number of years structuring these strategies and would be very happy to work with you and your advisers to further tailor this solution to reflect your fund's unique characteristics, objectives and constraints.

We are also happy to offer a bespoke training session with your committee to help them understand the above or similar strategies, and decide on a suitable approach.

AN EQUITY PROTECTION RECAP

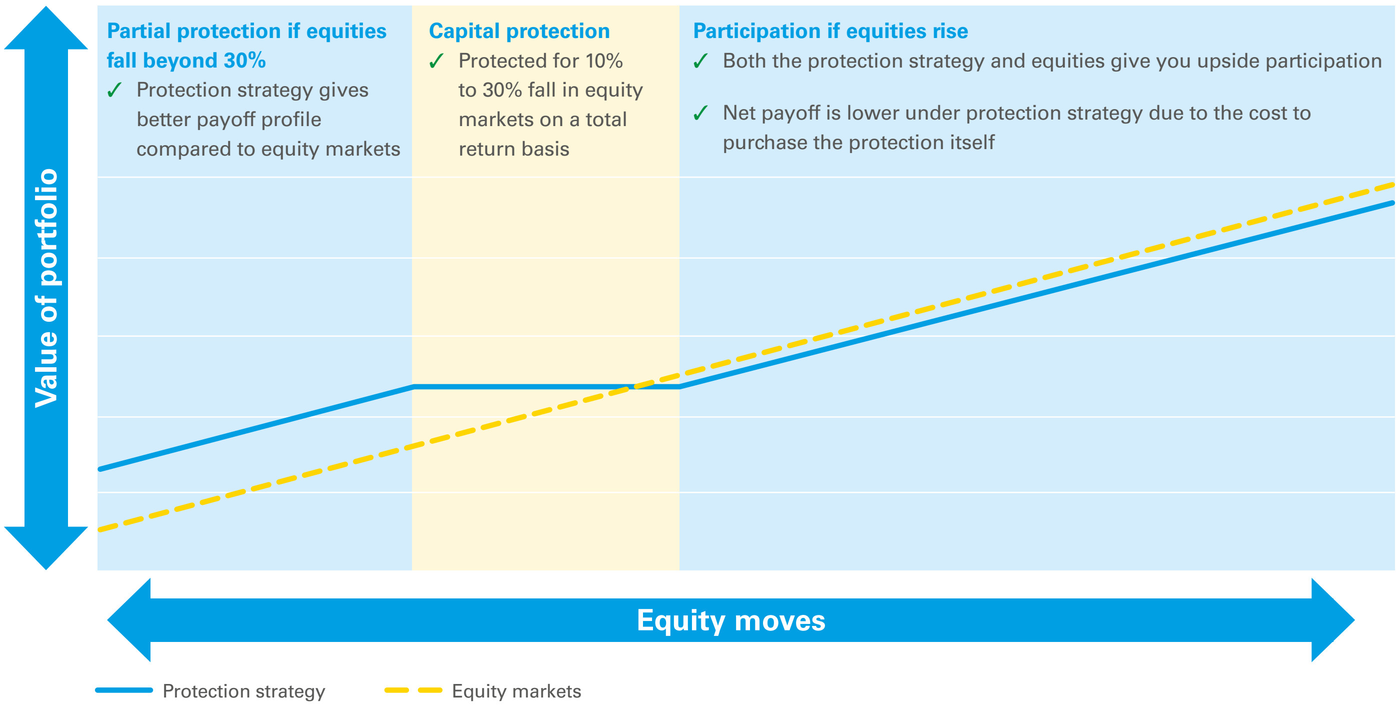
Buying equity protection is similar to buying insurance to protect against an adverse future event. Much like car insurance protects against the loss from an accident (over the excess), in this case the event to be insured against is the fall in the value of equities past a certain point. There are two main ways one can fund the purchase of this protection:

1. Pay upfront for the protection (i.e. write a cheque)
2. Sell your right to potential future equity returns in excess of a certain limit. This can generate the money needed to then pay the insurance premium for the downside protection (this has been the more popular strategy recently)

1. WRITING A CHEQUE FOR PROTECTION

The simplest approach to purchasing equity protection is to simply pay for the protection outright. The chart below shows how the value of the resulting portfolio changes under different equity market moves:

Figure 3: Paying upfront for protection allows full participation in any upside



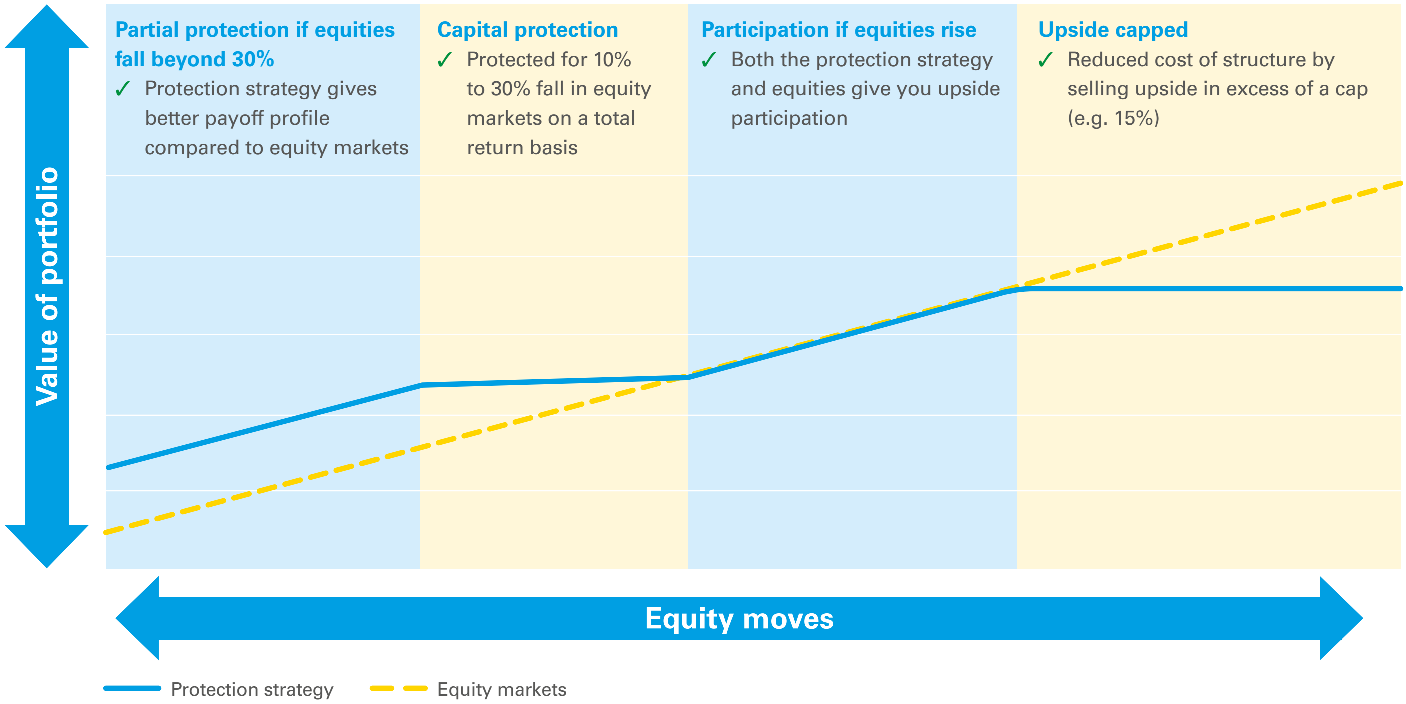
Source: LGIM analytics. Cost of protect against falls in equities of between 10% and 30% over the next 2 years

The portfolio is protected against falls in equities for the specified range, and retains the ability to benefit from any increases in equities (i.e. no cap on the potential upside).

2. SELLING AWAY UPSIDE TO BUY DOWNSIDE PROTECTION

An alternative to paying for equity protection outright is to sell to other investors your right to potential future equity returns in excess of a certain limit. The proceeds can be used to fund the premium to pay for the equity protection. The chart below shows how the value of the resulting portfolio changes under different equity market moves:

Figure 4: Alternative is to pay for protection by limiting participation in any upside



Source: LGIM analytics. Cost of protect against falls in equities of between 10% and 30% over the next 2 years

The portfolio is protected against falls in equities for the specified range, and retains the ability to benefit from any increases in equities up to a cap.

KEY RISKS

Derivatives may have greater volatility than the securities or markets they relate to. A change in value of a derivative may not correlate to a change in value of the underlying instruments. This may result in losses greater than the direct investment in those securities or markets. OTC derivatives contracts held (directly or indirectly) are valued using vendor supplied, model based and/or counterparty based data. OTC derivatives are contracts with companies such as banks or other financial institutions. If these companies experience financial difficulty, they may be unable to pay back the sums that they owe under the OTC derivative contracts.