

Investment News

Monthly Bulletin from the Investment & Risk Team

April 2016

Last Month in Brief

March saw the announcement of the eighth budget of the current Chancellor with a number of measures announced that may affect investment markets. The headline rate of corporation tax fell from 20% to 17%. This was accompanied with more generous relief on business rates in the latest attempt to try to stimulate growth in the economy.

Figures showed the UK's current account deficit widened to a record high in the final quarter of last year. The total deficit for 2015 came to £96.2bn or 5.2% of annual GDP with both figures the highest since records began in 1948.

Elsewhere energy price slumps kept the Eurozone in a state of negative inflation. The ECB launched another round of monetary stimulus by cutting its main interest rate to 0% and cutting its bank deposit rate from minus 0.3% to minus 0.4%. The bank also increased its quantitative easing programme in a bid to boost the economies of the Eurozone and expanded it to also include corporate bonds. This greater than expected stimulus led to volatility in investment markets including the euro experiencing one of the largest single day swings in the currency's history.

Chart 1: Equity Indices

Equity markets were less volatile than the previous month

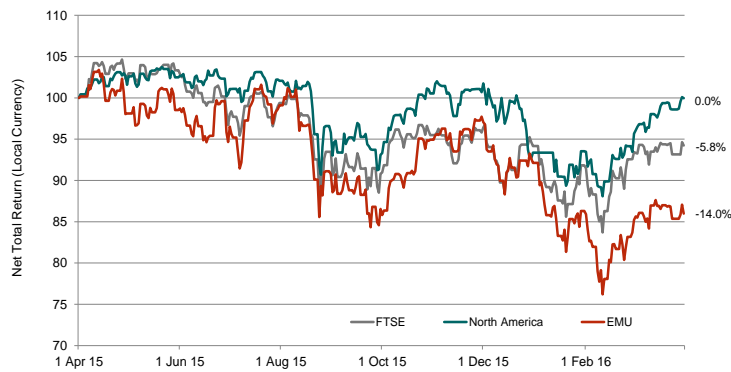


Chart 2: Sterling Credit Spreads

Credit spreads fell slightly during March

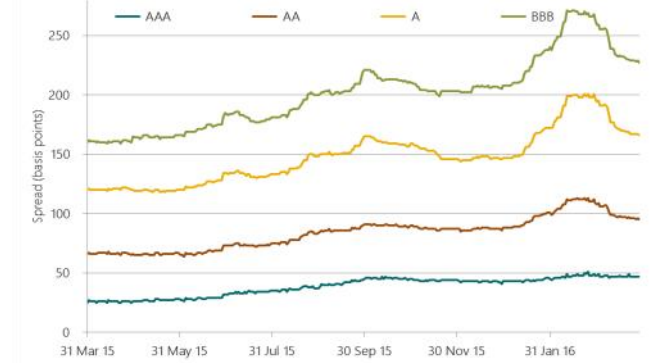


Chart 3: Gilt Yields

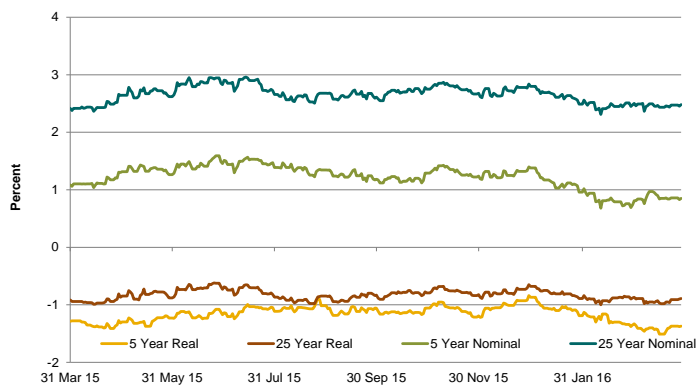
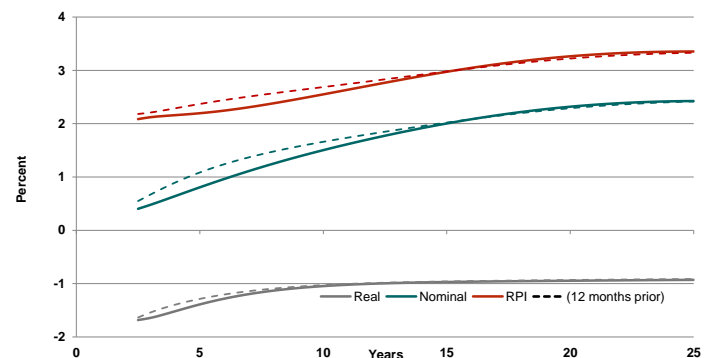


Chart 4: Gilt Spot Curves



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.3%	0.3%	Base rate	0.5%	0.5%
PPF 7800 funding ratio	79.8%	80.5%	\$/£ exchange rate	1.44	1.40
Halifax house prices (monthly change)	-1.4%	1.7%	VIX (volatility) index	13.95	20.55

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Managing Equity Risk Using Derivatives

Many private and institutional investors invest in equities with the aim of boosting the return of their portfolio. Equities can offer higher expected returns than less risky assets such as cash, especially in the long term. However, with the additional expected return there is also significant additional risk that price fluctuations can see the total value of investments fall rather than rise, sometimes significantly. When market volatility is higher than is tolerable for a specific investor they might wish to use derivatives to limit and manage that risk, rather than exit the market entirely.

Derivatives

Derivative instruments are financial instruments whose value is derived from the price of an underlying asset. There are a variety of different derivative instruments but those most commonly used to manage equity risk are:

- Options
- Futures
- Swaps

Each of these is described in more detail below.

Options

Options give the purchaser the option (but not obligation) to buy or sell the underlying asset(s) for a pre-specified price (the strike price) at a pre-specified date. A put option gives the right to sell the underlying asset and a call option the right to buy the underlying asset.

Options are widely traded on a range of securities such as equities and bonds with a range of maturities and strike prices. The market is very large and liquid for certain underlying assets, allowing investors and traders to open and close positions as and when required.

For a fund manager or investor (as opposed to speculator or day-trader for example) options are often used to limit the potential downside on a particular stock or index. If an investor wishes to participate in some of the risk, and therefore return, of an asset but is unwilling to risk losing the full value, then they might hedge some of the risk using options.

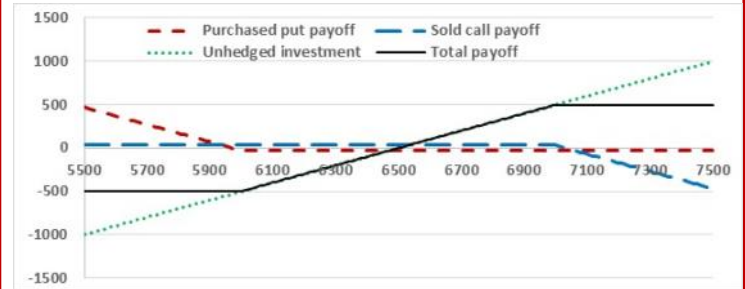
For example, an investor could purchase put options with a strike price of 6000 on the FTSE 100 index. If the value of the index in, say, 1 years time is below 6000 then the investor can exercise the option, which will compensate them for any fall in the index below 6000. The investor can therefore participate in any upside in the FTSE 100, whilst limiting potential losses over the time period of the option. However, there is a cost involved in purchasing options as the sellers will demand a premium for the option to cover the risks they are accepting.

Option strategies can be complex and structured to mitigate downside risks at no upfront cost. For example, the put option described above could be paid for by selling a call option on the same asset but with a higher strike price. This strategy, *shown in box 1*, would leave the investor with the returns of the underlying asset between an upper and lower threshold beyond which the gains or losses are capped. This distribution of returns would be desirable for an investor who is more concerned about large losses than the potential for large gains. This might be true of an individual who has invested a large

proportion of their wealth to save up for a large purchase in the future, or for an investor who feels that market volatility has temporarily increased and wants to limit the impact of this until stability returns.

Options do come with their own additional risks, especially if the instruments are not fully understood. For instance, selling uncovered call options (i.e. without also owning the underlying asset) can result in theoretically unlimited losses where the underlying asset price increases significantly above the strike price.

Box 1: Payoff varying by future asset price for portfolio with option-limited gains and losses.



Futures

Futures allow investors to completely offset the price risk of an underlying asset by agreeing to buy or sell an asset at a specified date for a specified price (this is an obligation and not an option). The motivation for entering such an agreement might be to lock in returns already achieved on assets following a period of strong performance whilst not being able or willing to sell the underlying asset immediately.

Swaps

Swaps are bespoke contracts, traded directly between institutions and investment banks, which means they are not often available or cost effective for smaller investors.

However, where they are used, an equity investor may enter into an equity swap or total return swap where they swap the regular returns from a stock or portfolio of stocks for a fixed, pre-agreed rate. This allows the investor to guarantee a fixed return from their asset(s) for a period of time without having to sell the asset. After this time they may sell the asset, enter into another swap or derivative contract, or continue with their unhedged equity exposure depending upon their requirements and views at the time.

Risks

Derivatives can also be used to increase risk. For example, they can enable an investor or speculator to gain exposure to the returns of risky assets without having to commit the full capital. This can be useful for, say, pension funds who want to gain exposure to certain assets to hedge against their liabilities but who don't have the level of assets required to achieve this.

Derivative investors are also exposed to counterparty credit risk, whereby the other party to the derivative defaults. The investor would then need to replace the derivative which may no longer be economically attractive.

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