NORTH CAPITAL

Spotlight:

Portfolio protection whilst maintaining equity exposure

October 2021

northcapital.co.uk

Portfolio protection whilst maintaining equity exposure

As global equities continued to hit new highs over the summer, investors are understandably becoming nervous about what lies ahead. Preserving capital forms part of growing capital, and if one can avoid significant drawdowns, as part of a long-term growth plan, so much the better. However, calling market peaks and troughs is notoriously hard, so we would never advocate trying to time entry and exit points. That said, there are ways in which investors can still maintain exposure to equities whilst taking a little less risk. Strategies include favouring fund managers that have a defensive style of management; passive funds that screen for lower volatility stocks; or engineering a return from the market through a structured product. Here we will discuss a few of these strategies.

Andrew Spence
Chief Investment Officer

Defensive fund management

A portion of fund managers believe that a portfolio that suffers fewer and less destructive drawdown will be in a better position to compound returns over the long run. These managers will tend to invest in quality businesses with the following characteristics:

> **Strong pricing power:** Essential products and services.

> **Stable franchise:** Sticky customer relationships; high switching costs; few/no rivals.

> **Barriers to entry:** Unique intellectual property (IP); cost advantages; high regulatory hurdles.

This will likely lead to businesses that have stable and recurring revenues, predictable growth and high free cash flow (a measure of profitability). An example fund that invests in this way is the Troy Trojan Income Fund. The fund invests in predominantly UK equities. Stocks within the fund, which exhibit many of the above characteristics, include: Unilever, Croda, Experian and Intertek. Over the long-term, the fund has provided solid compounding returns to investors and importantly cushioned drawdowns during periods of significant market stress (e.g. COVID stock market fall in 2020, and the financial crisis in 2008).

You might think this is an eminently sensible approach to have for much of your equity investments, but it can mean forgoing strong long-term returns, as investors tend to miss out on high growth companies as well as those companies that present good, shorter term, value for investment.

Lower volatility stocks

In a similar vein, if you are looking for companies to help reduce risk in your portfolio, screening for low volatility might help you in your quest. Factor investing, which screens for specific types of stocks, such as quality, value and low volatility has become a popular investment approach in recent years.

The low volatility factor has consistently shown to deliver equity market like returns, but at lower levels of volatility than a basket of stocks.

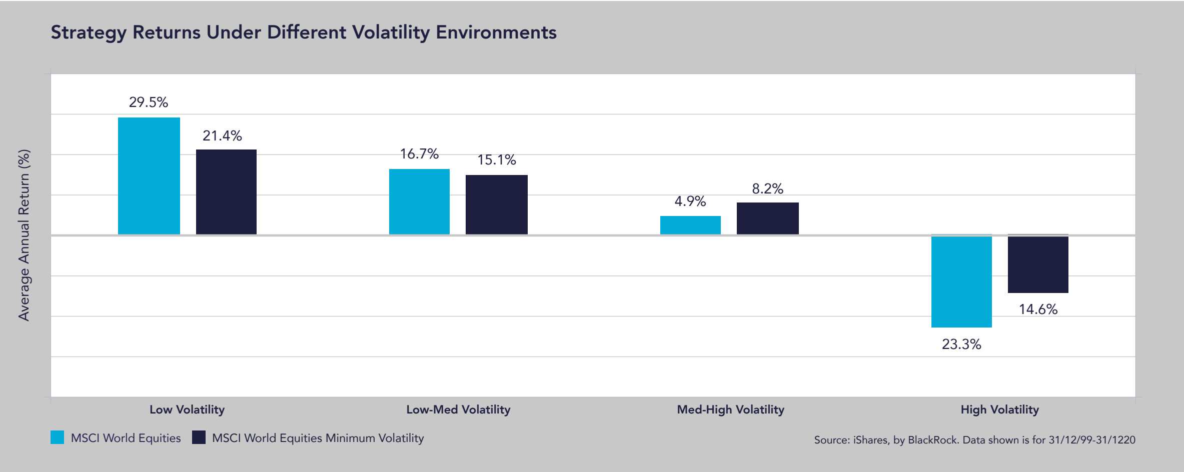
What we see from the data, is that during good times – when equity markets are very buoyant and volatility is low – investors in low volatility stocks still participate in much of the upside. The real value of this investment approach comes in the downside protection that has been shown historically, where screening for low volatility stocks has seen investors suffer far less significant falls during periods of market stress. Accessing this style of investing is predominantly done through a passive (factor driven) approach, through funds such as the iShares MSCI World Minimum Volatility ETF.

Structured products

Structured products have been available to investors for the last couple of decades under various guises. Essentially, they are investment products, typically sold through banks, that seek to provide a more defined return profile, than investing directly in equities. For example, if an investor had a view that equity returns were going to be relatively flat over the next 3-5 years, a product could be created to generate a return of 6-7% per annum in such an environment. Alongside this, investors can receive a degree of capital protection (up to a 40% fall in the index). Whilst this may seem too good to be true, investors do need to sacrifice a few things as part of this: they forgo dividends on their investments (which, in the case of the FTSE 100, is around 3%); they (in some cases) take on the issuing bank credit risk; and they do not receive upside in excess of this – should the underlying index (FTSE 100, for example) perform better than the product defined return (in this case 6-7% per annum).

How do they work?

Structured products are created using a bond from the issuing bank (e.g. HSBC) and a package of derivatives to create the designed payoff structure. The payoff structure may be an enhanced performance of an equity index (e.g. super tracker); benefiting from a range bound market (e.g. range accrual or autocallable); or generating a return providing an index does not fall below a certain level (e.g. synthetic zero). These would be individual products tailored to a client's specific views.



In recent years, there have also been unitised funds created that are a professionally managed package of structured investments. The most popular being a fund of autocall structured products. An autocall is a structured product that pays a high coupon if the underlying – typically one or more equity indexes – is above a predetermined level at annual observations dates, at which point it automatically matures and the investor's principal is returned, alongside any potential coupon return.

Defensive features can be incorporated into the products, where equity indices may be some way below their initial level and the investors can still receive a return. Two examples of funds in this space are the **AHFM Defined Return Fund** and the **Fortem Progressive Growth Fund**.

We have introduced exposure to these strategies in our discretionary range recently and whilst we are confident that current valuations are underpinned by robust earnings, we feel exposure to these approaches helps to diversify return, particularly through bouts of increased volatility.

NORTH CAPITAL

58 North Castle Street, Edinburgh EH2 3LU
+44 (0) 131 285 0860 info@northcapital.co.uk
northcapital.co.uk