The Case for Active Management of Hedged Equity

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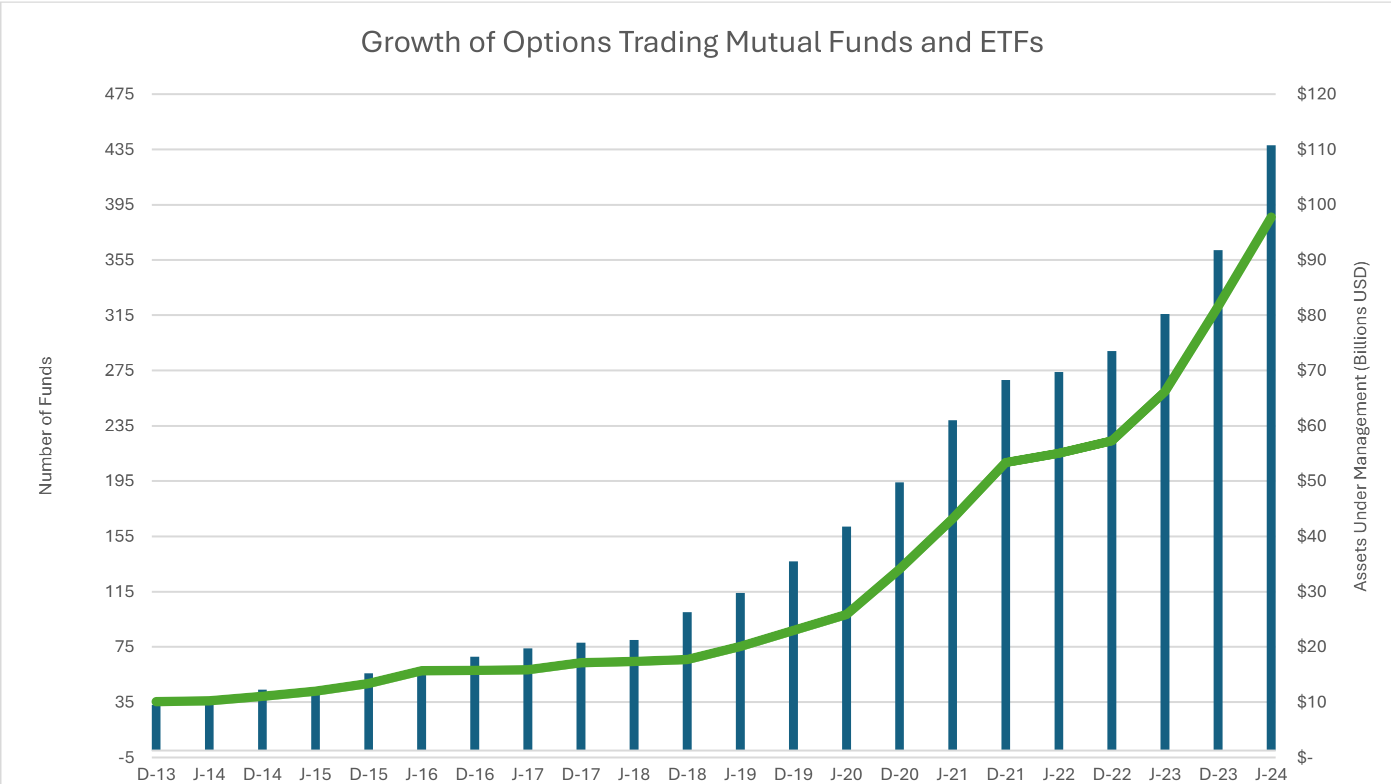
Swan Global Investments is a pioneer in [hedged equity](#) investing. Founded in 1997, Swan's motto has been "Always Invested, Always Hedged" for over a quarter century. There were very few money managers promoting hedged equity in the late 1990's.

Therefore, it has been gratifying and validating to witness the explosion of interest in hedged equity over the last five years. According to Morningstar, as of June 30th, 2024 there is almost $100 billion invested across 438 Options Trading mutual funds and ETFs.



	D-13	J-14	D-14	J-15	D-15	J-16	D-16	J-17	D-17	J-18	D-18	J-19	D-19	J-20	D-20	J-21	D-21	J-22	D-22	J-23	D-23	J-24
Count	33	35	44	46	56	59	68	74	78	80	100	114	137	162	194	239	268	274	289	316	362	438
AUM	$10	$10	$11	$12	$13	$16	$16	$16	$17	$17	$18	$20	$23	$26	$34	$43	$53	$55	$57	$66	$82	$98

Source: Morningstar Direct

What is interesting about the growth of hedged equity is that most of the assets are held in *passively managed* structures. Many hedged equity strategies are "set it and forget it", establishing their hedge points once a quarter or once a year. They do not consider market movements or try to maximize the value of their hedge.

In contrast, Swan has always actively managed its hedged equity strategies. Our [time-tested process](#) seeks to "sell high and buy low" by re-balancing the hedge and equity portions of its portfolios at opportune times. Swan believes actively managing hedged equity confers the following advantages:

1. Options aren't allowed to expire
2. Swan seeks to "buy low" during periods of market weakness
3. There is no explicit upside cap during bull markets

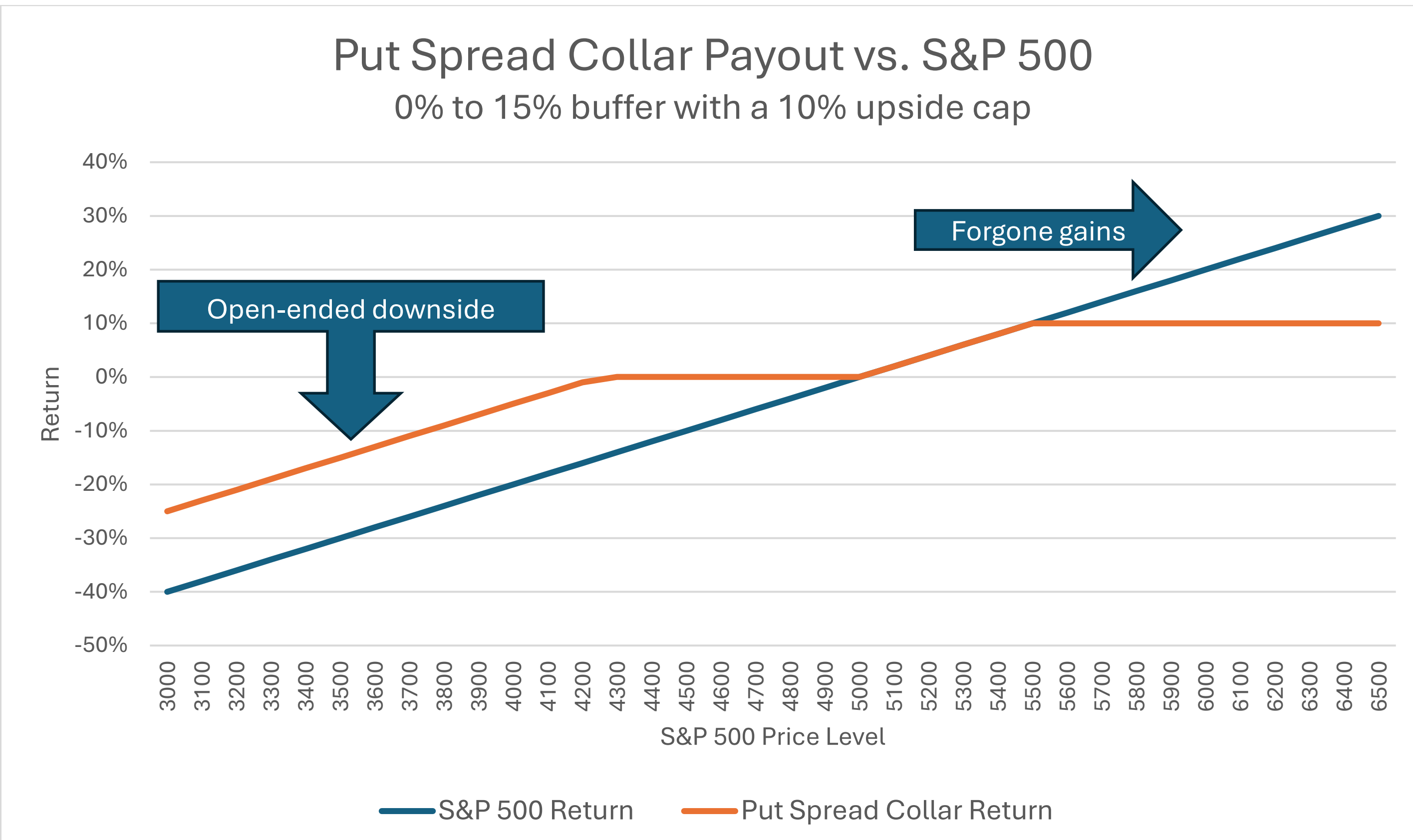
Before discussing the advantages of an actively managed hedging strategy, it is important to understand how most passively managed hedged equity funds are structured.

The Put Spread Collar: Simply Passive

Most of the buffered outcome ETFs as well as the largest hedged equity mutual funds are all employing variations of the same trade, known as a put spread collar. This trade has the following features:

- The put spread collar hedges a portion, but not all, of the downside risk.
- A put spread collar is designed to offer upside market participation up to, but not beyond, a certain point.
- The put spread collar is typically passively managed. It is set up once, and not altered until the options expire.

The put spread collar has a payout structure as illustrated below.



Source: Swan Global Investments

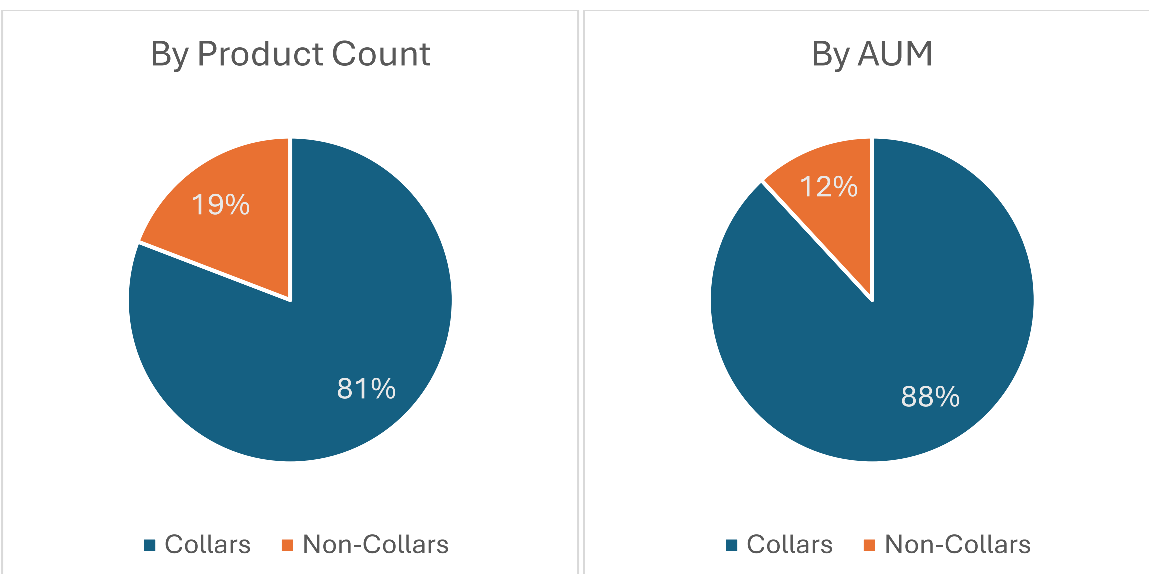
Once this trade is established, nothing else happens. It is a ***passively managed*** trade. Other than managing cash flows, the portfolio manager doesn't need to do anything until the options expire a quarter or a year later, at which point the trades are reestablished.

The advantage of the put spread collar in a *down market* is that if the market losses are modest, the investor will participate in little or perhaps none of the downside. The advantage of this trade in an *up market* is that if the market gains are modest, the investor will participate in most of the upside.

However, the disadvantages to the put spread collar exist when the market is up or down by more than a modest amount, i.e. a strong trending market.

- If the market gains exceed the upside cap of the put spread collar, then there's nothing to be done. The portfolio manager can't and won't adapt to "stay in the game." The investor forgoes the gains beyond the cap.
- If the market drops past the lower limit of the hedge, then there's also nothing to be done. The investor is on the hook for losses beyond that point, which might be considerable[1].
- Another disadvantage, perhaps harder to quantify, is based on volatility conditions. During times of elevated volatility or market stress, the purchase price of those long puts might be rather expensive. The portfolio manager might be forced to purchase an expensive long put and the trade-off would be to significantly cap upside potential.

The other concern facing put spread collars is simply the sheer number of strategies are essentially all doing a variation of the same trade. The graphs below illustrate that over 80% of the funds by both product count and AUM are utilizing a put spread collar or a traditional collar.



Source: Morningstar Direct, Swan Global Investments

The put spread collar trade is getting crowded. In contrast to this passive approach, Swan actively manages its hedged equity strategies. Swan believes active management offers several advantages.

[1] A close relative to the put spread collar trade is the collar trade. The collar doesn't have the open-ended tail risk in a market downturn, but the caps tend to be much lesser than in a put spread collar. Collars are common, but not as widespread as put spread collars.

Active Options Management: Acting Before Expiry

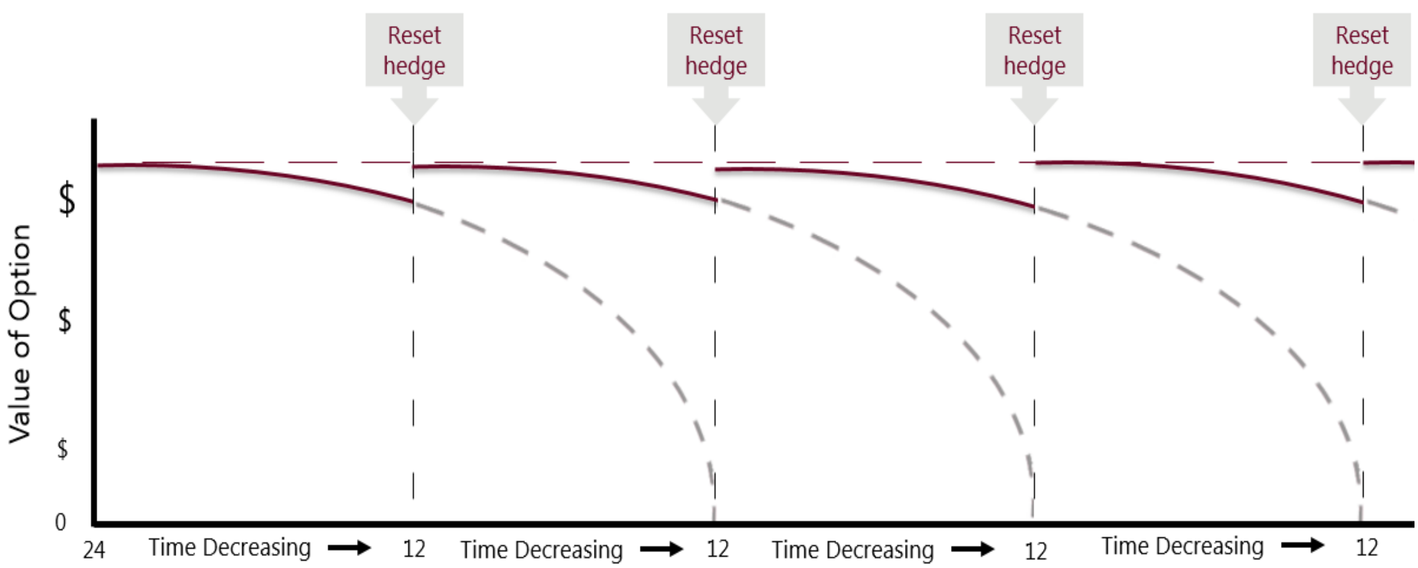
One fundamental truth about options is that every option eventually expires. If the option is not "in the money" at the time of expiration, it becomes worthless. The closer the option gets to its expiration date, the more it loses value. This is known as "time decay."

One key to understanding option pricing is that time decay does not happen in a straight line. Early in an option's life cycle the time decay isn't as costly. It's when the option gets closer and closer to expiring does time decay really start to negatively impact the value of the option.

For this reason, Swan typically uses put options with a much longer lifespan, typically expiring in two years.

- Swan will hold the put options for up to 12 months, during which time the time decay isn't as significant.
- Near year-end Swan's portfolio managers will actively sell the put options and replace them with new, two-year put options.
- This avoids the exposure to the steeper portion of time decay.

This annual rolling of the hedge is illustrated below.

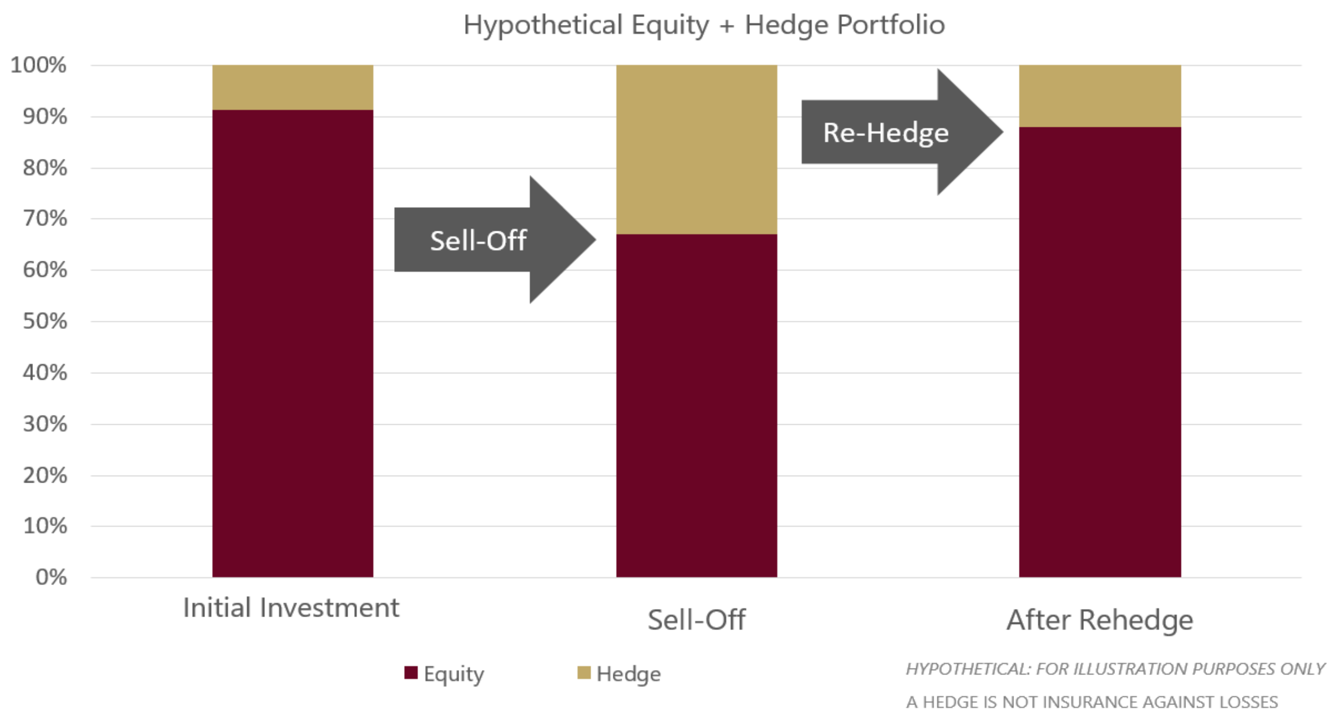


Source: Swan Global Investments

This contrasts with the buffered outcome ETFs. Buffer ETFs explicitly state that to realize the stated caps or buffers, one must hold the ETF for the full one-year period. Options are held to expiration, by design.

Active Re-Hedging: Seeking to "Buy Low" in Periods of Market Weakness

One of the cardinal rules for successful investing is "buy low, sell high." Swan's active management seeks to exploit periods of market weakness by "cashing in" the value of its put options during market sell-offs. The image below illustrates this process.



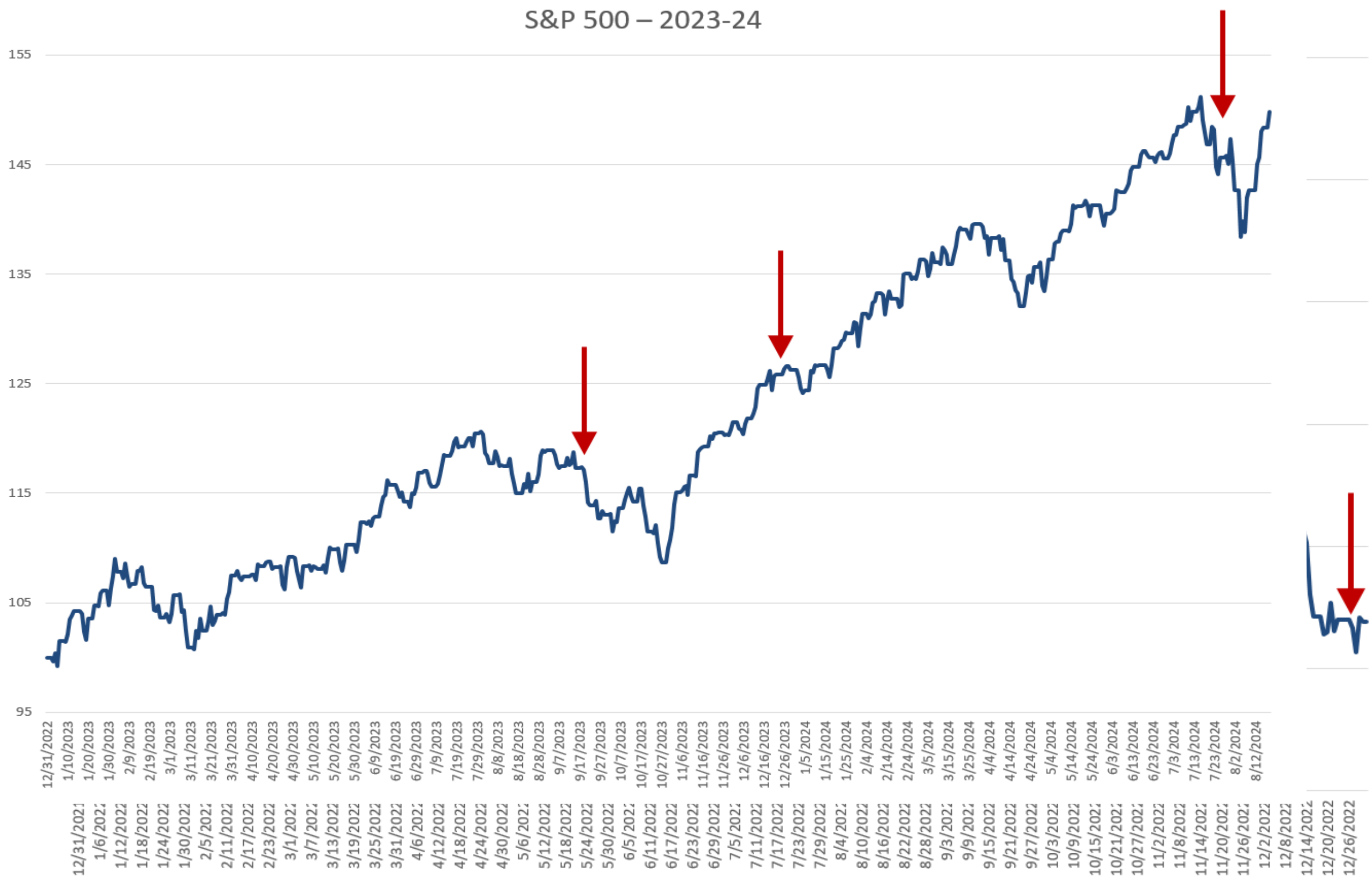
Source: Swan Global Investments

Swan's hedged equity strategies typically start the year with an equity-to-put option ratio of roughly 90:10. However, if the markets sell off significantly that ratio will change. The equity portion will track the market downwards while the put options should accelerate in value the greater the market sell-off. Rather than simply wait around for the market to recover, Swan's portfolio managers will typically:

1) sell some or all the put options at a profit,
2) purchase new put options at current market levels, and
3) re-invest the profits in the market, which is now trading at a low point.

We can see this active management of the re-hedge during the rising interest rate bear market of 2022:

- Swan's hedged equity strategies started the year with their put options set near market levels.
- As the S&P 500 sold off, Swan had designated breakpoints that would initiate the re-hedge process.
- Twice during the year Swan liquidated a portion of their put options at a profit, bought new put options, and purchased additional exposure to the S&P 500 while the market was at a low point.
- While Swan does not try to call the lows, the timing of the re-hedges did coincide with near-bottoms of the S&P 500.



Finally, at the end of 2022 Swan reset all its put options to avoid the steeper time decay as they approach expiration and to enter 2023 with the hedged at near-market levels.

This contrasts with the passive put-spread collar approach. In a year where the S&P 500 was down 18%, a defined outcome fund with buffers of 10% or 12% would have been exposed to losses beyond that point.

Source: Morningstar Direct

In addition, a buffered fund has no mechanism to "buy low" while the market is at its low point. The investor can either sell out of the ETF or wait for the options to expire and the trade to reset.

Actively Seeking More Upside: No Explicit Cap

The flip side of the previous situation is active management in an up market.

If the market moves up significantly, Swan's portfolio managers can and will replace the existing put options with new put options featuring a higher strike price.

By doing so, the fund is actively engaging in some profit-taking in a bull market.

Source: Morningstar Direct

Moreover, it is ratcheting up the hedge level, so if the market reverses the new put options are in a better position to offset the downside risk. The graph above illustrates the active management during upwards markets.

Swan has set higher re-hedge points three times since the start of 2023. Two were intra-year re-hedges, where a portion of the put options were rolled up to higher strike prices. The other re-hedge occurred in late 2023 when all the put options were exchanged for new put options with a two-year expiration cycle to avoid the steep drop-off in value described previously.

Again, this active management stands in contrast to the passive approach used by buffered outcome funds. If a buffer fund had a one-year upside cap of, say, 12% in 2023, it would have left a lot of money on the table when the S&P 500 was up 26.3%. Unless the investor sells the ETF, they must wait for the existing options to expire before receiving a new cap.

Conclusion

To be clear, Swan Global Investments is not opposed to put spread collars or buffered outcome funds. We are quite pleased to see hedged equity play a larger role in investor allocations. There is no one single strategy that performs best in all environments and there will be situations when buffered ETFs perform well.

However, Swan believes active management can add value within the hedged equity space. By managing the cost of hedging via rolling out of the put options before they expire and by "selling high and buying low" Swan seeks to provide a better outcome for its investors.

About the Author:

Marc Odo, CFA®, FRM®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fitsinto an overall investment strategy. Formerly Marc was the Director of Research for 11 years at Zephyr Associates.

Important Notes and Disclosures: