

*Suitable for wholesale/sophisticated investors*

## Efficient equity protection to improve returns

Volatility markets can be used to create **cost-effective equity protection**.

In this note we explore how efficient protection can reduce equity risk and increase returns.

### Designing protection

Over a cycle equities are expected to deliver strong returns, hence their role in most portfolios. However, they come with the risk of large drawdowns.

Reducing drawdowns can deliver better compounding, so equity protection can make sense even if it is a small drag on portfolios in most years.

When considering equity protection, there are two key design decisions.

**First, can protection be designed to be both cost-effective and reliable?**

Always purchasing put options will deliver gains when equities fall, but it can be expensive over time (see the CBOE PPUT options performance in Figure 1). Investors should examine ways to reduce the expected protection cost while retaining most of the gain in equity falls\*.

**Second, how can investors pay for the protection so it isn't a drag in most years?**

While well-designed protection can improve equity returns over a cycle, it is expected to be a drag on returns when equities don't fall. Investors that don't want to underperform in most years can look at ways to 'pay for' this protection cost. While adding equity beta to make the protection 'beta-neutral' is a relatively simple way to do so, it will cause additional losses when equities fall. Investors should explore whether there are other, more suitable, approaches of paying for their protection.

\* For a more detailed discussion of creating cost-effective protection see our paper 'Volatility for alpha and protection'.

### Complementary, dynamic, cost-effective protection

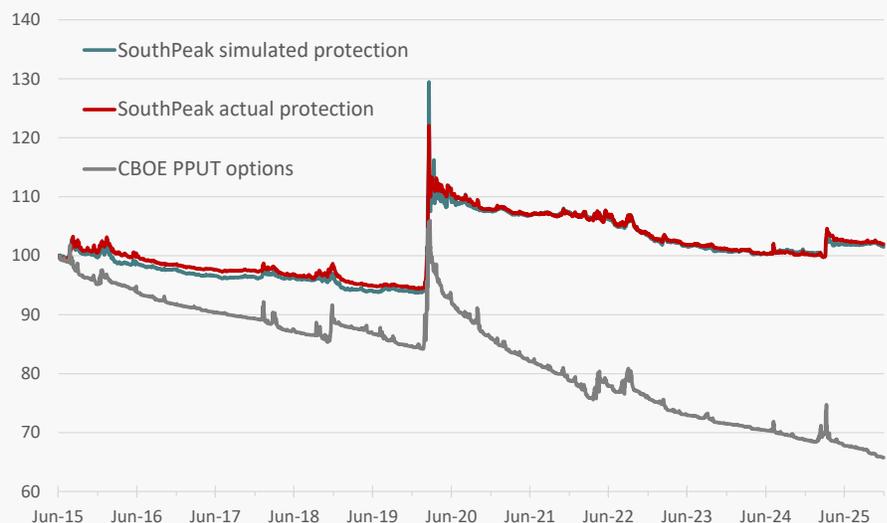
SouthPeak has used systematic protection in our absolute return fund for 10+ years. We employ two key actions to **target cost-effectiveness with reliability**.

First, we use several complementary strategies so that each protection strategy works best in a different type of equity crash. Every market crash is somewhat different, so there may be little benefit in designing protection purely based on what would have worked best in the most recent crash.

Second, we dynamically manage the strategies to mitigate the 'bleed' based on an understanding of the source of the cost behind each protection strategy.

As figure 1 shows, **SouthPeak's protection has delivered positive returns over the past 10 years**, despite very strong equity returns in that time. It also shows that the actual performance is in line with the simulated performance, which is important for when we look at simulations over longer periods.

Figure 1: Performance of equity protection strategies (daily returns)



*Simulations have been created using models with assumptions and may have the benefit of hindsight. There can be sharp differences between simulated and actual results for many reasons. The simulations are net of estimated transaction costs but gross of management fees.*

*Actual performance is calculated from the returns of the strategies in SouthPeak's real diversification funds. Returns are net of transaction costs and management fees, unaudited and subject to adjustment.*

*CBOE PPUT options is the estimated performance of the options in the CBOE PPUT Index (1-month 95% strike S&P500 put options). It is calculated as the difference between the SPXT and PPUT Indices.*

*Past performance is not an indicator of future performance. See important information on the last page. Source: Bloomberg, SouthPeak.*



## Paying for protection to improve total returns

Adding SouthPeak's protection to an S&P500 portfolio would have improved returns by 0.8% p.a. since 2000 by significantly reducing drawdowns, saving 16% of losses in negative equity months (see Figure 2). However, it would have caused a slight drag most of the time, with the portfolio capturing only 91% of equity returns in positive equity months.

If an investor increased their equity exposure by 10% (e.g. via futures) they would have improved this positive month equity capture to 101%. Total return would have also improved, despite 10% worse performance when equities fell.

**Risk-managed short volatility strategies are our preferred way to 'pay for' protection.** We believe they have a significantly better risk/return profile than equities and, further, that they can be designed to be defensive, driving the better outcomes shown below.

Using a risk-managed short volatility strategy to 'pay for' the protection would have provided the same positive month equity capture as 10% extra equity exposure with better performance in negative equity months, **delivering returns of 3.8% p.a. above equities with lower drawdowns.**

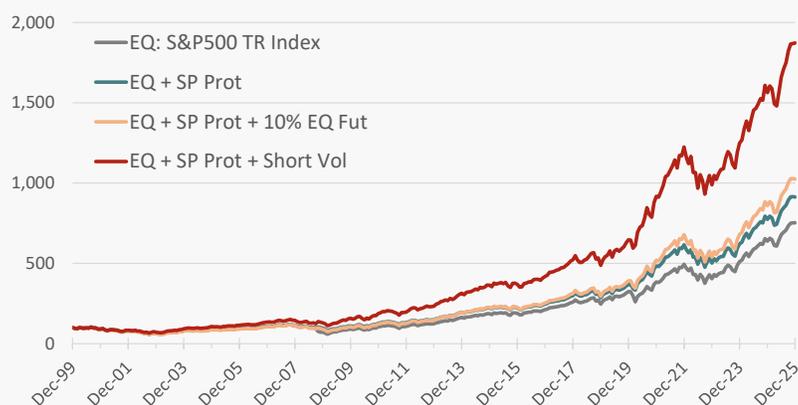
## Practical considerations

Adding equity protection to portfolios can be difficult; including challenges around protection design, how to 'pay for' the protection and implementation through an external manager or by trading derivatives directly.

**By combining passive equities with cost-effective protection and risk-managed short volatility, the SouthPeak Australian Equity Fund aims to provide investors with a simple way to improve returns and add resilience.**

*For further information see our paper 'Adding returns and resilience to Australian equities'.*

Figure 2: Simulated performance of S&P500 Total Return with different protection strategies (monthly returns)



31 Dec 1999 - 31 Dec 2025	Eq	Eq + Prot	Eq + Prot + 10% Eq	Eq + Prot + SV
return p.a.	8.1%	8.9%	9.4%	<b>11.9%</b>
volatility	15.1%	13.3%	14.7%	<b>13.9%</b>
max loss	51%	40%	44%	<b>36%</b>
<i>equity capture</i>				
+ve months	100%	91%	101%	<b>101%</b>
-ve months	100%	84%	94%	<b>82%</b>

*Simulations have been created using models with assumptions and may have the benefit of hindsight. No actual investments were made. There can be sharp differences between simulated and actual results for many reasons. The simulations are net of estimated transaction costs but gross of management fees.*

*See important information below. Past performance is not an indicator of future performance. Source: Bloomberg, SouthPeak.*

## Important information

**DISCLAIMER.** This document has been prepared for wholesale investors for the purpose of providing general information, without taking account any particular investor's objectives, financial situation or needs. It does not constitute a recommendation, offer, solicitation or invitation to invest. Investors should obtain their own independent advice.

This document contains "forward looking statements" which are based on assumptions that contain risk and uncertainty, and the views of SouthPeak's principals at a point in time. These are subject to change without notice. Actual results and events may differ materially from those in any forward-looking statements.

No representation is made that SouthPeak's strategies, investment process or risk management will be successful, or that any investor will not suffer loss of principal. Subject to any law to the contrary, SouthPeak disclaims all liability for any loss or damage suffered by any person acting on information provided in, or omitted from, this document.

## Contact us

Level 21, 25 Bligh Street, Sydney NSW 2000, Australia

t: +61 2 8071 4321 | invest@southpeakim.com | www.southpeakim.com

## About SouthPeak

SouthPeak is a specialist volatility manager providing alpha and protection.

We aim to deliver attractive outperformance with low correlation to bonds and equities.