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Finding the right diversifier: Fixed income versus equity downside hedging

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We've been spoiled. How could we not be? Bonds were a three-decade panacea, providing reliable downside protection and consistently high returns. Year 2022 seems to have brought all of that to a screeching halt: global bonds are seeing their worst year in a generation and inflation risk makes them unreliable hedges. Investors should be scrambling to fill the hole left in their toolkit.

The stimulative central bank put (which, along with deflation fear, historically sent bond prices soaring whenever equities fell) has given way to an army of skittish inflation hawks and a succession of bad days for both stocks and bonds. Investors should not be surprised. Historically, in inflationary environments (including much of the prior century) rising inflation signals an impending recession, bond yields rise as inflation compensation (they rise further in anticipation of hawkish tightening), and equities fall as recessionary earnings projections are discounted at higher rates.

Indicators suggest the worst may be yet to come. Inflation has surged but has not made its way into long-term yields. Equities have wobbled, but so far have not imploded. Sticky inflation could mean crisis-level equity declines and a wholesale repricing of bonds to include permanent inflation and hawkishness.

Paradoxically, traditional inflation hedges offer little assistance: (1) traditional inflation hedges like commodities are linked to short-term inflation, which have already soared and could easily fall; (2) inflation-linked bond returns are protected from changes in inflation expectations, but the combination of bonds and inflation protection isolates exposure to real-yields, which (as we saw in September this year) jump at the thought of persistent inflation.

While combining growth assets with crisis offsets is a cornerstone of modern investing, none of the typical strategies are likely to work at this time. We find ourselves asking now what?

Let's be honest, it's not all bad—higher yields improve performance expectations and likely enable de-risking. That said, for any risk level, the portfolio construction puzzle is better solved with an available crisis hedge option. Crisis hedges dampen volatility, preserve capital in a drawdown, provide dry powder after a crisis, and enable more growth asset exposure for the same downside risk. Downside protection in portfolios is valuable, and the strategies that have worked seem likely to disappoint in the future. To find a substitute, Investors may need to look beyond the typical investment universe and push beyond their comfort zone.

One alternative is structured equity hedges: downside-focused hedges benchmarked to equity options. Structured equity hedges may offer reliable protection and could replace the role of bonds. They can be expensive, but they typically provide reliable protection. Additionally, active implementations can reduce hedge costs.

Another alternative candidate could be a subset of systematic factor strategies that are liquid and designed for negative correlation with equities. Factor strategies are programmatic trading strategies designed in advance to seek positions or pairs of positions that have an intended risk and return profile. Factor strategies gained popularity in the last decade and defensive strategies (like equity and bond trend) can be

isolated for greater portfolio impact. Keep in mind that generic implementations do not maximize crisis hedging.

The portfolio construction game may have changed but all hope is not lost. For as long as the inflation story persists, investors will just need to work a little harder to fill the void left by bonds.

We are here to help!

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