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Hybrid Equity Strategies Generating Interest As Institutions Look To Increase Downside Protection

In an attempt to gain further alpha in its portfolio while minimizing downside losses, the Oklahoma State University Foundation investment committee sought an equity manager that could do something different.

The committee's goal was clear—find a strategy that could capture 70% of the equity upside and limit the downside to 50%.

Following a search process, the fund selected Gargoyle Group, an Englewood, N.J. -based investment manager that offers an active options overlay strategy, which has exceeded the investment committee's expectations thus far.

"Up to this point it's only an 18 month relationship, but they've done very well," said Ryan Tidwell, director of investments at the Stillwater, Okla.-based foundation.

While they do not have the mainstream popularity as institutional hedge funds, hybrid equity strategies are becoming viable alternatives for nonprofits seeking protection during sudden market falls. And if the OSU Foundation's short-term success with the strategy is any indication, it is possible that more institutions will begin to entertain maiden or increased allocations to the sector in the near future.

Understanding Hybrid Equity Strategies

Traditionally, hybrid strategies have been defined as a product that combines two or more different financial instruments, such as securities with both debt and equity characteristics. Over the years, the most common example is convertible bond strategies, but firms such as Gargoyle have also launched active options overlay strategies that fall under the "hybrid equity" heading, but are unique in their own right.

Josh Parker, president of Gargoyle, said that the firm's strategy is based upon a philosophy that institutions have touted for numerous years—increasing performance over a long-term horizon, reducing volatility and finding ways to mitigate losses when markets are down.

And from January 2000 through June 2011, Gargoyle's strategy has simultaneously increased long-term performance by 326 basis points per year on average, reduced volatility by over 30% and reduced the worst monthly loss by almost 20% as well, according to Parker.

So why haven't more nonprofits jumped at the chance to capture the returns associated with this type of strategy? Brian Rowe, director of manager research at Seattle-based investment consultant Wurts & Associates, said that the answer is multifaceted.

"I think [nonprofits] have a longer term liability structure and to be honest, some of the strategies don't generate sufficient income for the complication that the strategy brings. You have to understand options and go into volatility, and a lot of folks are reticent to get into that optionality," he said.

Rowe said that institutions have not been completely devoid of hybrid equity strategies in their portfo-

lio, and have gained exposure using convertibles or a dividend rotation strategy, which does not require as much sophistication to understand and arguably provides a more predictable return stream.

William Lowery, ceo of Chicago-based investment consultant Lowery Asset Consulting, said that while the firm has no aversion to hedge fund strategies, the lack of transparency and high fees led them to seek another source of alpha for the OSU Foundation, which is one of its nonprofit clients.

"We were basically looking for ways on a value add proposition to reduce beta exposure on the equity side and hopefully not hurt our return," he said.

He said that the concepts behind the strategies that firms such as Gargoyle and The Clifton Group utilize is not foreign, but agreed that it has not been widely adopted by institutions. Lowery said that in his firm's case, their level of comfort with options strategies has afforded them the opportunity to clearly explain and recommend them to clients, and said that any hesitancy to invest in the strategy by other funds, if at all, could be due to misconceptions.

"Part of it may be an aversion of options being lumped into derivatives," he said, adding that that there is little to no leverage associated with the types of hybrid equity funds that Lowery recommends.

Getting Around Historical Opinions of Hybrid Strategies

Tom Lee, a senior portfolio manager and principal at The Clifton Group, said that historically, hybrid equity strategies have not garnered the popularity of asset classes such as hedge funds, but that this view among institutions has been changing over recent years.

"In general, many investors still struggle with options strategies and many managers struggle explaining it," Lee said. "Many think of leverage as speculation, and managers need to do a good job of explaining how options are used in a strategy to control risk and enhance return, and not only convey this to a CIO and staff, but also an investment committee, which is sometimes where it becomes difficult."

He said that the Minneapolis-based firm's new defensive strategy, launched earlier this year, has garnered interest from institutions, particularly nonprofits, as it has been designed to contain no leverage whatsoever and provide an overall tail risk hedge to their portfolios.

"My experience [with hybrid equity strategies] has been that people are quickly able to get around their opinion about options, because it gives them reasonable upside and a fair amount of downside protection," he said. "All investors are looking at that today, even nonprofits, university endowments or foundations are giving more thought to 'what are the liabilities they have to fund on an ongoing basis and how do they structure their portfolio to meet those liabilities?' They're not only thinking of themselves as a 100-year investor, but they're thinking how can they fund liabilities year in and year out if they experience a market like we did in 2008, and having something to provide downside protection is appealing to them."

In Oklahoma State's case, Parker said one of the attributes of Gargoyle that the fund was attracted to is its ability to adjust the portfolio as the market goes up and down, rather than being 100% long as market goes down or 0% as the market goes up.

"We base (the strategy) on a buy-write but use index call options because they are, in general, overpriced. In addition, we dynamically manage the options portfolio because, if we really want to be hedged, we want to be hedged 31 days of the month. We don't want to risk a market run-up and be 0% long or risk a market tank and have 100% exposure," Parker said. "We target 50% long, watch the net long market exposure, and keep it within a 15% band. The moment it goes below 35% long or above 65% long, we will make an options play that adds theoretical value and brings us back within the band."

"We use a modified buy-write because index options are overpriced, and we want to maintain a hedge every minute of every day, and not let that hedge fluctuate based on the market," he said.