Insights
Equities

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Equity Downside Protection in 2023

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Given the uncertainties of today's market environment, investors may wish to consider different scenarios and downside protection approaches with the aim of better positioning their portfolios to weather volatile markets.

How Bumpy Is the Road Ahead?

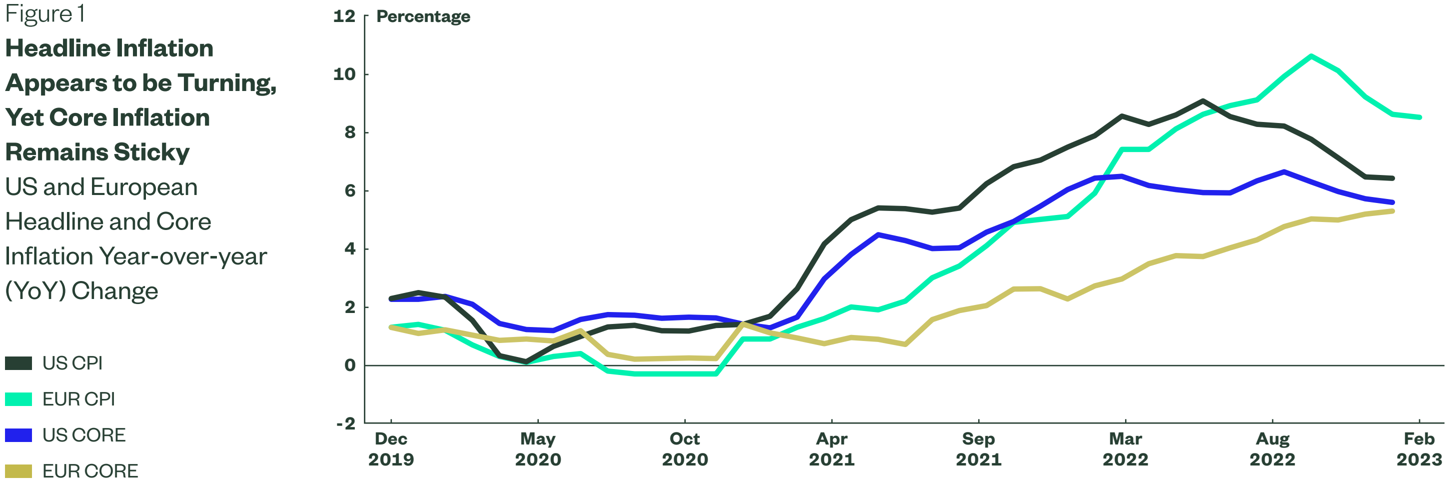
The current market environment is immersed in uncertainties. Market sentiment in 2023 has shifted from seeing a soft landing or a hard landing to a hard landing or worrying about which surprises could still hit us and lead to a market shock.

In a recent blog, Chief Economist Simona Mocuta cautions against an overly hawkish interpretation of the recent data flow, and argues the disinflation narrative remains well anchored. This supports the view of a soft landing (see 1 in Reference).

In a separate State Street Global Advisors publication (see 2 in Reference) we describe six Grey Swans that could unsettle markets in 2023. Our darkest Grey Swan is that of an outright deflationary bust. In this hard landing scenario central banks deliver multiple rate hikes while unemployment increases. Amid the weakening global demand and improved supply, oil prices tumble to send a deflationary impulse through the economy.

A possible market shock might also be triggered by a major oil price hike, another one of our Grey Swans. With the Ukraine War, past OPEC+ production cuts, and Russian sanctions as a backdrop, a larger-than-anticipated economic response to China's scrapping of COVID-19-related policies could stoke oil demand from Chinese industry and be the catalyst for renewed surging energy prices.

Figure 1
Headline Inflation Appears to be Turning, Yet Core Inflation Remains Sticky
US and European Headline and Core Inflation Year-over-year (YoY) Change



Source: Refinitiv. Data between December 31, 2019 and February 28, 2023.

Equity Downside Protection Strategies

Against such a backdrop how should investors position their portfolios? Some investors may need the higher expected returns afforded by equities but worry about their risk. Others might think moving into fixed income is still too early as central banks are still raising rates. One possible solution may be to remain invested in equity for the time being, yet combined with some form of downside protection, or alternatively move into a low volatility equity strategy (see 3 and 4 in Reference). In the following sections we enumerate some possible scenarios and potential strategies which could be used.

1. **Soft Landing** In this scenario the equity market keeps trending upward and volatility continues to drop.

- **Potential defensive strategy: A put-spread**

In an upward trending market, most defensive strategies would see a performance drag versus the market capitalization-weighted benchmark.

— If we had moved into a low volatility strategy a drag relative to the market capitalization-weighted benchmark is expected, the size of which is not known in advance.

— If a put option was bought, it would expire worthless. The investor's loss would have been the paid premium, otherwise enjoying full market participation. We believe now could be a reasonable time to enter into such a contract. The S&P 500 put premiums, for example, are around one-third of their highest levels seen during the COVID-19 market drop, though they are still not back to their much lower pre-COVID-19 levels. Reducing the premium (but reducing the downside protection) while retaining full upside potential could be achieved through a put spread.

2. **Sudden Market Shock** In a second scenario, the markets experience an unexpected event shock and the already vulnerable markets exhibit a strong sudden downward shock, just as was experienced during the COVID-19 shock in March 2020. A reactive rebound will follow.

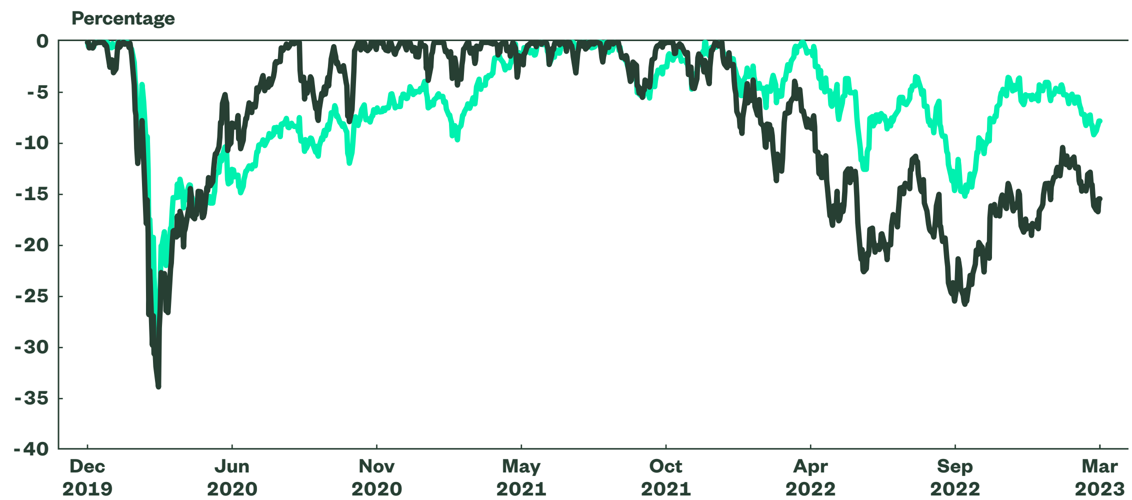
- **Potential defensive strategy: A simple put option**

There will always be a reactive rebound after a market shock where investors re-enter the market. Having said that, the length or size of the rebound is not known and the unprecedented rebound seen post mid-March 2020 would unlikely be repeated, given the reduced appetite for fiscal stimulus given inflation worries.

— During the COVID-19 pandemic period referred to in Figure 2, defensive equity only had a slightly reduced drawdown relative to the market capitalization-weighted benchmark as can be seen in Figure 2. This however is not a failure of such strategies since we tend to see that securities react alike to the general bad news (systemic event) and temporarily there is no distinction between, for example, a defensive or a cyclical security. This still holds for the immediate rebound. After that in the unfolding recovery, securities' idiosyncratic characteristics re-emerge and the defensive equity will likely lag the market capitalization-weighted benchmark.

— Having a put option already in place prior to the shock would have been fruitful. The put option protects below the initially agreed strike level, cushioning the fall. The value of the put option is at its highest at the bottom of the market and if sold at this moment the investor would have crystallized the gain, well exceeding the initial premium. If kept, the option will again ultimately become worthless in the rebound. Still, the put option allows for smooth sailing through the market turbulence.

Figure 2
Evolution of the Drawdown for the MSCI World Index and the State Street Global Advisors Global Managed Volatility (GMV) Fund



Source: State Street Global Advisors and Refinitiv. Data between December 31, 2019 and February 28, 2023.
Past performance is not a reliable indicator of future performance.

3. **Hard Landing** In the third scenario equity markets resume the descent of 2022 in a highly volatile environment.

- **Potential defensive strategy: Low volatility equity**

— Such a market environment is the sweet spot for low volatility strategies: defensive characteristics of the securities are best captured and a relative outperformance can be realized. This can also be seen in Figure 2 where, for example, the State Street Global Advisors Global Managed Volatility Fund had a significantly reduced drawdown during 2022 relative to the market cap-weighted MSCI World Index.

— For an option strategy, the benefit of the strategy would depend on the premium paid, which could be relatively high in a highly volatile market environment. It may be preferrable to buy a collar instead for it allows for a reduced premium.

Figure 3
Expected Outcomes for Different Defensive Equity Strategies Across Market Scenarios
Potential Strategies are Indicated as Well

Possible Market Scenario 2023	Potential Defensive Strategy	Low Volatility Equity Strategy	Option Strategy
Soft landing	Put spread	Expected lag in up trending market (although uncertain magnitude)	Put spread has low cost of premium while retaining full upside potential
Market shock	Put option	No relative benefit in the strong drop. Likely relative underperformance in the rebound	Simple put that protects fully against tail risk while retaining full upside potential
Hard landing	Low volatility strategies	Relative outperformance	Collar has low cost of premium while retaining full downside protection

Source: State Street Global Advisors.

Closing Remarks

In these uncertain times many investors are looking to hedge their equity allocations. While there are ample ways to achieve a hedging approach, risk and return outcomes depend strongly on the selected downside protection strategy one chooses. To illustrate this point and to help guide investors through these decisions, we have examined three hypothetical market scenarios and provided perspectives on the potential outcomes for an option based strategy and a low volatility strategy.

Reference

1. "On the Recent Strength in US Economic Data", Simona Mocuta, 01 March 2023.
2. "Six Grey Swans That Could Unsettle Markets in 2023", Lori Heinel and Gaurav Mallik, 26 January 2023.
3. State Street Global Advisors Global ESG Screened Managed Volatility Fund (SSGA GMV).
4. State Street Global Advisors Global ESG Screened Defensive Equity Fund (SSGA GDE).

Option Strategies

Put option = a contract where the buyer pays an upfront premium. In exchange the investor is protected against a drop below the agreed strike level at a defined maturity date.

Put spread = reduced premium through a combination of a bought put at a certain strike level and a sold put at a lower strike level, foregoing protection below the lower strike level.

Collar = reduced premium through a combination of a bought put at a certain strike level and a sold call at a higher strike level, foregoing upside gain above the call strike.

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- Build from breadth
- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of December 31, 2022 and includes approximately $58.60 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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