

# Risk Management for Institutional Investors

(MARKET RESEARCH PROJECT)

## KEY HIGHLIGHTS

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# Background

Institutional investors represent a significant stakeholder and customer group to the Australian Stock Exchange (ASX).

Options enable institutional investors and traders the opportunity to enhance portfolio yield and manage portfolio risk by offering additional strategies to change exposure to underlying share portfolios. As well as providing a market and trading platforms (via brokers) for the trading of options, ASX has recently started offering institutional investors free tailor-made education on the management of market risk in Australian equity portfolios. This is aimed at portfolio managers, performance measurement staff, risk managers, stock analysts, senior management and senior portfolio strategists.

ASX commissioned Creative Catalyst Insights (an independent market research company) in conjunction with Morningstar (technical market expert) to conduct qualitative research among different institutional investor groups, in three stages: fund managers, asset consultants and superannuation funds.

The overall aim of this research was to gain an overall understanding of awareness, knowledge and application of options as a risk management tool among institutional investors to assist in the development of education, marketing and communication strategies.

In total 40 in-depth interviews were conducted, 20 with fund managers (March to May 05), 13 with superannuation funds and 7 with asset consultants (June to August 05) in Sydney, Melbourne, Brisbane and Canberra.

- Fund managers included those not involved in options, those currently active in options and those inactive. Fund sizes ranged from \$50 million to \$10 billion, with mixed client bases (retail, institutional) and a mixture of styles.
- Asset consultants represented integrated consulting and research team, separate consulting and research teams (sector/class) and research team only. Also, there was a spread of attitudes towards options.
- Superannuation Funds included both public and non public funds; industry, government and corporate funds, ranging from \$118 million to \$15 billion and with members of 1,500 to 660,000. Size of the fund appears to be a key differentiator for the existence of an in-house investment team and so for in-house sophistication of knowledge.

All those interviewed were Executives, including CEO, Chairmen of Boards, Directors, Heads of and Chiefs.

ASX wishes to thank all those who participated in this research.

# Key Findings

Key findings are divided into:

- ⇒ Investment Process and Risk Management
- ⇒ Derivatives – Attitudes, Awareness and Usage
- ⇒ Options – Triggers and Barriers
- ⇒ ASX Role

## Investment Process and Risk Management

- The three separate groups had differing levels of involvement and ‘closeness or distance’ to options and derivatives, as well as to risk management in general.
- At **fund manager** level, the requirement is for both a philosophical sanction of the use of derivatives as well as the hands-on skills base. They are able to articulate more specific reasons for their involvement/lack of involvement in the options market.
- Being key advisers to super funds, **asset consultants** are a key conduit to the selection of fund managers for super funds. While they have the intellectual understanding of options/ derivatives and the role it plays, comments are at an overview perspective rather than a hands-on level.
- Most **super funds** in this research relied heavily on asset consultants to guide them on asset allocation and fund manager decisions. Hence, perceptions and attitudes towards options and derivatives were guided not only by these asset consultants but also by the perceived attitudes and risk appetite of the Board of Trustees.
- Other, larger **super funds** had their own in-house research team and relied more heavily on their own decisions to guide investment philosophy and direction.
- Because of the differing nature and understanding of derivatives, some sections of the research are only relevant to particular groups.

## Investment process

- All **super funds** had a highly defined investment decision process. Typically respondents were either a member or a key advice resource to the Investment Committee. Investment Committees usually comprised investment savvy representatives from the Trustee Board as well as external and independent consultants who delegate work to the in-house investment team/asset consultant. The Committees are responsible for the selection of fund managers etc, with Trustee Boards being ultimately responsible for making the final investment choice decision.

## Key investment advisors

- Larger **super funds** with in-house investment teams use asset consultants on an ad-hoc basis, mainly for specialist knowledge. For other funds, the asset consultant relationship is viewed as an essential partnership in terms of offering a full service (ie initial strategic advice on asset allocation, selection of assets/fund managers, establishing mandates and risk management statements, risk measurement, and risk and performance monitoring).

- All **super funds** also regarded custodial services as a critical partner for administrative services, fund accounting, derivative exposure monitoring and mandate compliance monitoring.

### Investment risk defined

- Across all three groups, investment risk is simply defined as “falling short of objectives and benchmarks”. It is the risk of losing capital, of not performing to objectives, of not being competitive with peers, of performing substantially different to the market and of not out-performing the market.
- All in all in comes down to stock risk (diversifiable for fund managers) and market risk (diversifiable for super funds via different fund/asset class selections).

*“Risk usually means the risk that you will lose some sort of return or capital so really risk is to do with mainly a return from our perspective and if the expected return doesn’t occur then you remove the manager ..... many people look upon risk as a separate entity in itself, risk to me is an integral part of your return” (Large corporate super fund)*

### Risk management tools

- Risk management tools differ for each group in terms of the extent of their hands-on involvement in selecting asset classes, fund managers, fund or stocks. These are:
  - Strategic asset allocation for asset consultants/super funds
  - Diversification of asset classes and of different fund managers and within them different funds for asset consultants/super funds, and diversification of stock and sector levels for fund managers
  - Selection of asset class and then fund manager selection (styles, type of fund) for asset consultants/super funds, and of stock/sector selection (research) for fund managers
  - Risk Management Plan, ie the establishment of risk management statements of fund managers for all groups
  - Tight monitoring systems and reports, ie monitoring of performance against objectives and mandates and tracking error, again for all groups. For asset consultants this also meant the available systems/software technology to be able to look at the impact of derivative decisions on portfolio risk.

## Derivatives – Attitudes, Awareness and Usage

### Derivatives perception

- With the exception of the two large corporate funds with in-house investment teams, **super funds** generally view derivatives as the domain of asset consultants. They are usually included in the mandate for most funds except when they are not a part of the fund type eg emerging markets; small caps etc. A minority of super funds have restricted mandates for 'general' funds, as they have specialist funds to cover derivative usage (eg. passive re-balancing, hedging, tactical asset allocation).

Overall, among **super funds** there is a limited awareness of derivative usage *“as long as the fund manager does it within mandate restrictions and meets performance objectives...”*

- Options cause concern due to a lack of detailed knowledge and a strong perception of options as “risky” among **super funds** (a perception fuelled by the press, APRA’s requirements for risk management statements and conservative Trustee Boards of smaller super funds). Derivatives, especially options are *“seen as a side issue ....not worth the effort ...too much hassle, too many restrictions...”*

*“there is a sort of view amongst a lot of our customers that you are actually taking risk even though you are using it to reduce risk.”* (Fund Manager)

*“... the institutional market is a very strange market, they don't seem to care about capital gains & they don't seem to care about franking credits....tell them [Super Funds/Clients] about the tax element of the churn & all those things .... you get them interested then they can start asking questions of the managers like why don't you use call options to earn some more income & why don't you... you never ask those questions of trustees because half of them wouldn't understand a call option... derivatives”* (Fund Manager)

- While **asset consultants** are generally supportive and knowledgeable about derivatives, they are led by the risk appetite of their clients or clients’ mandate. They perceive that not many fund managers want to use options or have the skills, hence they rarely use options in presentations.
- A few **asset consultants** were opposed to the use of options in their funds for tactical asset allocation (TAA). Sophisticated users of options (ie large asset consultant and large super funds with in-house investment teams) were the exceptions, being comfortable using both futures and options.

*“managers who do not run a risk model are dangerous ....risk you don't know is dangerous.”*

- Among **fund managers**, those who claim to use individual stock options use it a) as a peripheral risk management strategy; b) as a ‘funding strategy’ in a ‘bald’ market, or when the market conditions are attractive; c) to generate extra income; d) to manage tax impacts.
- While there is a mix of sizes, styles, client bases and benchmark awareness in both the non-option **fund manager** user group and the option user group, option users tend to be more benchmark insensitive (due to nature of the fund, ie absolute return focus, niche markets, small cap etc); are more ‘boutique’ funds, tend to have a more entrepreneurial mindset/attitude and have skills in-house.

## Derivatives Usage

- While technically many of the strategies are the same, it is interesting to note the difference in terminology between **fund managers** and **super funds/asset consultants**:
  - ↳ When **fund managers** use options, they are used for risk management, hedging, to increase income (ie buy write strategy in static markets), sell calls to generate more income and premiums, to defer capital gains or as a funding strategy.
  - ↳ Among **super funds** and **asset consultants**, options are used as transitions between managers, to deal with cash balances and to re-balance portfolios (mainly SPI), for exposure (not in physical stock), for tax minimizing, capital management, adding value, protection and risk management.

*“if you’re using options as a risk management tool it’s buying insurance, it’s protecting your downside and if that’s what you’re expecting to do then it’s protecting your capital.”* (Fund Manager)

*“I don't really see it as a separate asset class its just an extension of an underlying position that I have got where I will look at how the options are being priced and have a view that’s a reasonable way of hedging our existing positions... it’s just an extension of what we are doing.”* (Fund Manager)

*“the biggest positive is you can alter your exposure without moving your physical position and if you are tax aware ..... earn some income AND reduce your exposure without realising a capital gain.”* (Fund Manager)

*“Long/short management has created an opening because the consulting community accepts that unpredictable things can happen in the short-term.”* (Fund Manager)

## SPI Futures

- Generally speaking, when mentioning derivatives, respondents think more about SPI Futures as they appear to be comfortable and hence acceptable.
- SPI Futures are used actively by the majority of fund managers to manage cash flows and to equitise the cash component of a portfolio because they are cost effective, simple to execute and understand, create symmetric returns, and are liquid.
- SPI futures are the ‘easy & acceptable’ face of derivatives among super funds and asset consultants, especially for maintaining strategic asset allocations, for transitions and for passive re-balancing.

## ETOs versus Over-The-Counter options

- Regardless of whether a **fund manager** was engaged in the options market or not, there was a preference for ETOs compared to over-the-counter options because the latter raise issues of counterparty risk and are dependent on the other party who control the prices.
- **Asset consultants** and **super funds** with in-house investment teams prefer ETOs; even those **super funds** with low awareness generally appear more comfortable with ETOs.

## The 90s change

- When asked to consider why the fund management environment used derivatives more extensively in the late 80s early 90s compared to now, these were some of the speculative reasons:
  - ↪ Regulatory environment changes, eg APRA now does not allow options for speculation or gearing, and asset consultants now have '*strong preference for more structured and longer time frame perspectives on equity management*'.
  - ↪ Current market conditions – "*life has been a bit easy for fund managers recently...it is easy to add value in a growing market ...a 'rotating bull market' ...we haven't had a crab market in some time.*"
  - ↪ Reduced use of balanced funds being replaced with specialist funds (eg passive overlays, re-balancing, dedicated TAA funds, hedge funds etc)
  - ↪ Market consolidation in the late 90s reduced the number of middle market players who historically provided much of the options volume. (The emergence of boutiques may see that middle market re-populated)
  - ↪ More proactive broking back then
  - ↪ Small/medium funds got bigger and options liquidity is now seen as a concern.

## Options – Triggers and Barriers

### Asset Consultants

#### Triggers

- Capital management – effective use of capital (exposure)
- Customisation - can structure a particular payoff
- Options - adding value
- Transitions (mainly SPI)
- Re-balancing via passive overlay – helps "*mitigate against function of size*" –re-weight position for specific position and period (SPI + options)
- When not confident, safer to use derivatives as may not be able to get out of physical stocks (large asset consultant)
- Tax minimisation (on prompting)
- Protection
- Risk management
- Options vs SPIs – market in specific stock options is deeper
- Terminology – fund managers tend not to be responsible for the liability so focus on 'adding value'

#### Barriers

- Client conservatism – perceptions that options are risky
- Regulations fuel this discomfort - monitoring requirement/ risk management statements
- Fund managers not asking to use/not talking about it
- Expensive way of achieving objectives – fees high & option pricing high. Other (cheaper) ways of controlling risk at a macro level. Not efficiently priced
- At a fund level not keen on tactical short-term decision-making (TAA) have a long-term philosophy
- Options an asymmetrical risk
- Portfolio systems don't allow for options at a stock level. Systems to account, measure risks.
- Liquidity levels
- Hands-on experience (AC and FMs)

## Super Funds

### Triggers

- Transitions (mainly SPI)
- Re-balancing through passive overlay (mainly SPI futures)
- Hedge funds
- Adding value at the peripheral – adding potential out-performance at the peripheral
- Lock in a good return – limit downside
- Usage usually approved in mandate - as long as within performance parameters

### Barriers

- Big picture strategic asset allocation “swamps everything”
- “too much hassle/restrictions”
- Misuse – bad news stories
- Trustee boards – may see as risky – conservative
- Lack of understanding of use of options in effective strategies
- Terminology – difficult concept to put across particularly in a negative environment
- Regulations & risk monitoring requirement. Derivatives are associated with risk in negative sense – red tape
- Exacerbated by APRA/ASIC apparent discomfort
- Returns measured before tax

## Fund Managers

### Triggers

- Risk management – protection/hedging:
  - ↳ Protect downside
  - ↳ Protect tax position
  - ↳ Manage volatility around a share price
- Earn extra income - adding depth and breadth to a portfolio:
- Competitive edge
- Management of long/short money
- Market conditions
- Some speculation – for retail investors

### Barriers

- Front-end barriers
  - ↳ Philosophically opposed
  - ↳ Client mandates
  - ↳ Client understanding
  - ↳ Fund Manager environment
- Options market & market conditions
  - ↳ Liquidity
  - ↳ Cost
  - ↳ Transparency & anonymity
  - ↳ Lack of skills and understanding
  - ↳ Hard work
  - ↳ Lack of understanding of portfolio impact
  - ↳ Current market conditions
- Back-end barriers
  - ↳ Compliance complexity
  - ↳ Back-office handling/ understanding

## ASX Role

- Generally ASX is positively perceived in the derivatives area. There is the perception that ASX has been very active, with good results in the retail user end of the market. Super funds and asset consultants felt that ASX could “get options more talked about”, therefore provide education opportunities.
- There was little awareness of the ASX Investment Manager and Trustee guides. There is a need for these to be distributed more widely and placed on the website.
- From all three groups “anything that educates Trustees is good”, being mindful that Trustee Board members are extremely busy, ‘new’ investment decision-making have long lead times (up to 6 months), hence the need to go them, eg presentations at conferences they ‘have’ to attend ( eg ASFA, CMSF).
- Fund manager clients need training in the impact of options in reducing tax and need empowerment to ask their managers if they are doing the right thing for risk management and for tax.
- Need for improved transparency and to encourage all to talk about it more openly.
- Need for education for compliance and systems – at fund manager level, educate back-office; at super fund level, custodial services education.
- Other specific education ideas relating to **fund managers** were to offer tailored solutions and tools, eg how they could use different tools to ‘add value’, have the ASX options valuation tool as a downloadable Excel add-in tool, conduct/provide research/case studies, hold seminars with international speakers and investigate new products/developments eg ratio fund, structured products with share market characteristics.

# Final Comments

- Options are not top-of-mind among the three separate groups:
  - ↳ Those **fund managers** using options are not talking about it, just doing it (considering it a competitive edge).
  - ↳ While **Asset consultants** are aware of the value of options, they are not promoting them because of client risk attitudes, perceived lack of skills of most fund managers and not necessarily being in line with long-term investing views.
  - ↳ **Super funds** have low awareness of the value and Trustee Boards tend to be conservative, seeing options as risky.
- Increased **fund manager** options activity and increased ‘publicity’ will cause a ripple effect through **asset consultants** to clients. Currently this is being hampered by the amount of client option wariness.

*“Need to train portfolio /investment managers to think physically and derivatively – for example if you want to go longer in BHP, what is the impact if a) buy physical or b) get exposure derivatively. Look at risks of all market movements.” [Large asset consultant]*

- There is the need to arm **fund managers** with skills and reasons to use and talk about options usage, and to create acceptance among asset consultants and super funds by arming them with positive reasons and examples for the need and usage of options.
- ETOs are *not* automatically regarded as a risk management tool; therefore other reasons for using options should also be communicated. For example for **fund managers** - adding value, to position defensively, tax effectiveness and a return to TAA; for **asset consultants** – adding value, passive re-balancing, currency overlays, managing transitions from one manager to another and changing strategic asset allocations (SAA); for **super funds** – protection & income, tax effectiveness, re-balancing, transition management and SAA and TAA.
- Need to empower **super funds** to ask questions, eg is your fund manager doing the best for your fund with regards to risk management? tax? re-balancing? transition management?
- Further promote ASX Guide to options to Trustees and reach Trustee Board members at existing industry conferences (ASFA – November; CMSF – Easter).
- There is an opportunity to provide **fund managers and asset consultants** with case studies/practical application seminars on better tax outcome for clients, performance difference between users and non-users of options, use of options in different markets, and how successful fund managers are using options. Other opportunities exist in having international speakers at seminars, offering risk budgeting software for options portfolio risk assessment and communicating ‘success stories’.
- Potential development of new ‘packaged/bundled’ options contracts.