Derivatives can protect against crisis but performance drag an issue

Key points

- *Derivatives offer a cash effective way to gain exposure to equities.*
- *They helped protect portfolios in the recent COVID-19 downturn.*
- *However, derivative programs come with a cost and can be a drag on long-term performance.*

Investors who set up derivative programs before the COVID-19 crisis were able to take advantage of the severe market dislocation, but cost remains a key factor to consider.

Frontier Advisors Senior Consultant, Joe Clark, said using futures and swaps provided investors with a cash efficient way to gain market exposure at a time when liquidity concerns were high.

"It meant that investors didn't have to have all of their money tied up and also because investors could be very nimble and quickly move exposures around in a way that they wouldn't with a fully funded investment, say investing in physical."

Investors have various implementation options including equity futures, swaps, ETFs and options, which all have different attributes. The best path depends on the investor's goals and the investment scenario.

Which is best? Depends on the scenario

Method	Stress market (e.g. COVID19)	Short term tilt (e.g. 3-6 months)	Medium term tilt (e.g. 3 years)
Passive			
Futures			
ETFs			
Swaps			
Options			

Whatever the program, it is important to be set up a before a crisis, he said.

"It can take up to four weeks depending on implementation manager or the bank to get the documentation in place, so it's important to do it before the crisis comes – it's very difficult to get everything set up in the middle of a crisis."

Various derivatives offer different solutions

Clark said futures are extremely liquid but performance can vary. During the COVID-19 period (January to June 2020), Australian futures underperformed physical equities by about 50 basis points, whilst US futures outperformed physical equities by about 50 basis points.

"It goes to show that, particularly in a crisis, these differences where you're implementing with derivatives can become much larger than they would be. The volatility of that difference will tend to increase."

Swaps deliver a perfect match to the underlying index but ending the contract early attracts a break cost. Funding costs are key because they can blow out above LIBOR, which peaked at 4% during the GFC and more recently 1.5% during the COVID-19 crisis.

"Swaps allow very customized exposures to be built for clients over the medium-term that have very specific baskets."

Options can be used to create something close to futures exposure with the same downside exposure but allowing more participation on the upside.

"One of the big considerations for options is that it's expensive to get an exposure which gives you a payoff in a crisis."

Meanwhile, ETFs are less liquid, particularly under stress, and fees often determine how much performance differs from the underlying index.

Key questions the panellists answered

- *(31.00m) If I wanted to substitute equity exposure for derivatives on a longer term time horizon, what do I need to consider and is it different for smaller investors?*
- *(31.50m) How much does pricing materially impact the decision to use derivatives?*
- *(33.30m) What is the price differential across types of options?*
- *(38.40m) Has Frontier considered any applications for derivatives in hedging infrastructure or REITs?*