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# Asset owners embrace flexibility of derivatives

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Derivatives have entered the mainstream as asset owners increasingly use them to protect against equity market falls, inflation and other risks.

Frontier Senior Consultant, James Bulfin, said options are commonly used to protect against market falls, with some investors choosing an indirect approach to lower costs.

"Costs are a key consideration for any downside protection strategy, and indirect hedging involves using derivatives on one asset to hedge another. While indirect hedging can provide more effective hedging, it also introduces a degree of basis risk."

Current call options pricing is attractive and could be used to give investors who are underweight equities a greater exposure to a market rally if it climbs above five per cent.

Derivatives can also be used to manage the risk of rising inflation. One strategy is to buy an inflation-linked swap (a breakeven inflation swap is a derivative on which a fixed rate payment on a notional amount is exchanged for payment at the rate of inflation).

"Breakeven swaps have outperformed outright yields since COVID-19, causing negative real rates. This is because inflation expectations have been rising, while nominal real yields have been suppressed by monetary policy forces such as quantitative easing."

ESG derivatives are a relatively new product allowing investors to implement responsible investing views at a whole of portfolio level. MSCI expanded its ESG index range in 2019 and launched ESG futures in March 2020, although they are mainly focused on Europe.

"We found there to be a clear, positive correlation between an increased government focus on climate and social solutions, and investor demand for sustainable investment products," Frontier Consultant, Donna Davis, said.

These ESG derivatives can still deviate from the price of the underlying asset, leading to tracking error or underperformance. Investors also need to be aware that less liquid ESG equity indices can incur higher transaction costs due to lower liquidity.

Bulfin said derivatives are also being used by investors to reduce the carbon intensity of their portfolios.

"Buying a carbon offset derivative gives investors the ability to offset the carbon footprint within their portfolio by including an allocation to offset emission certificates. This can also express specific views of the carbon price, and therefore benefit from future movements of the price of carbon offset emissions."

While there are a growing number of ways asset owners are using derivatives, they also face the question of how to implement them. Investors weighing up whether to go through an outsourced, advised, or insourced route need to consider their internal team's current appetite for complexity and their capability.

"Have a think about how quickly you want to be able to respond and react to be able to implement a decision once a market event has occurred," Davis said.

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