How to manage risk and capital efficiency in BTP portfolios

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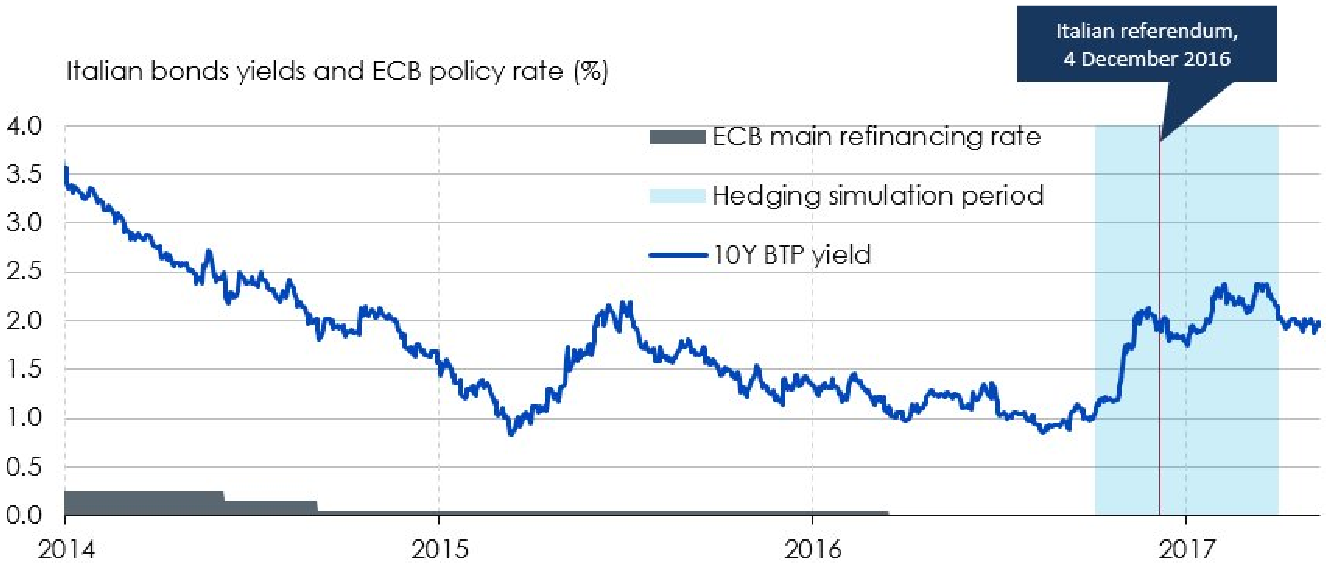
In terms of broad strategic asset allocation, as of the end of 2016, Italian investors on average had a 42% exposure to bonds, making it the single largest asset class. Within Italian bond portfolios the typical allocation to domestic government bonds is substantial at 60%. This is somewhat higher than the European average of 51%, although in line with German and French investor allocations. With such a high weighting in purely domestic bonds it is important for investors to consider a pure BTP-related hedging solution as opposed to the broad Euro-denominated debt hedge that we have previously analysed.

Whilst Bund hedging is appropriate and efficient for general Eurozone exposure, BTPs incorporate a higher degree of specific country and political risk, with a yield premium to Bunds that has varied considerably over time. Due to the non-homogeneity of BTP risks compared to Bunds investors with substantial BTP holdings may be best served with a dedicated BTP-related hedge.

Figure 1: Hedge your fixed income exposure in times of political uncertainty



Click to enlarge

Period: 01 January 2014 to 10 May 2017
Sources: WisdomTree, Bloomberg. Past performance is not indicative of future returns.

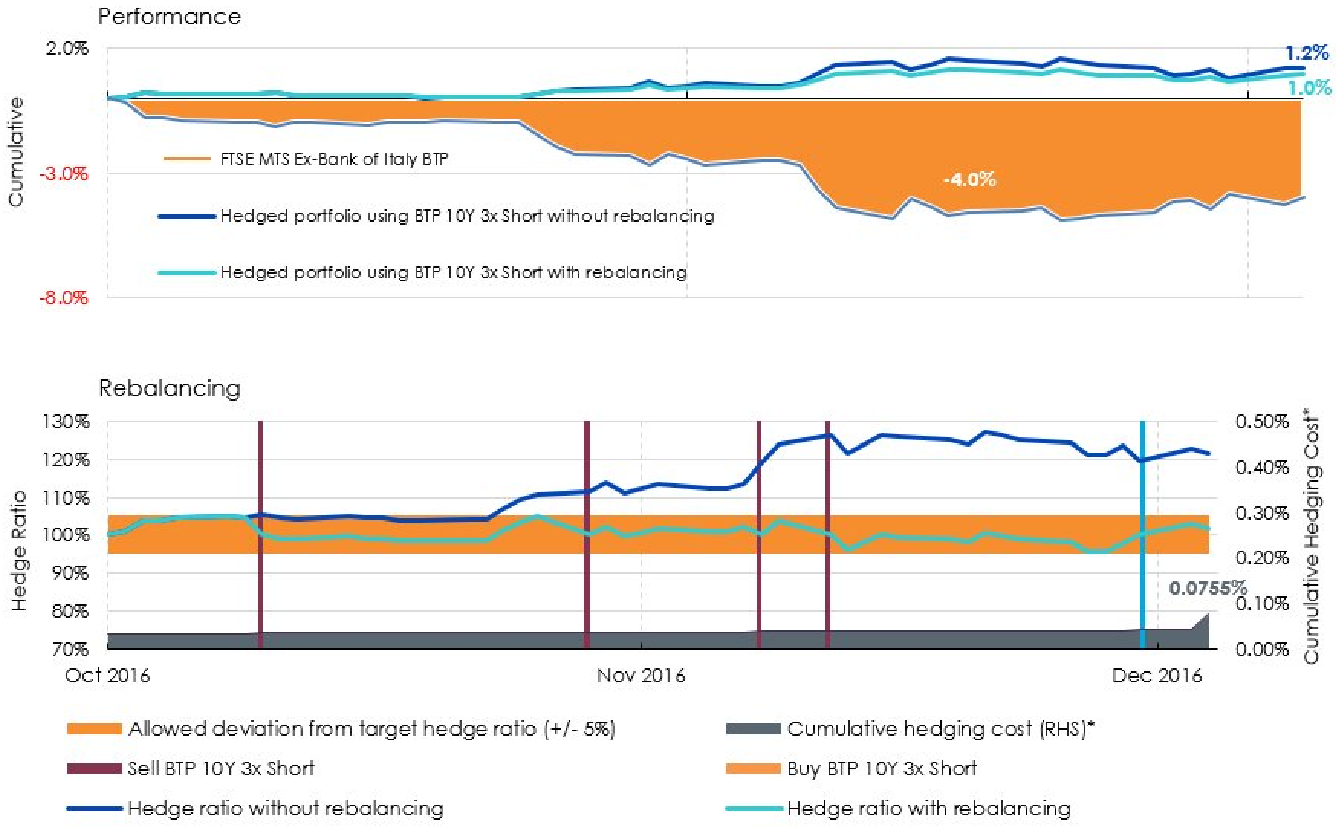
For many investors hedging is not just about protecting the capital value of the underlying portfolio, but also managing total portfolio volatility. In this context, investors, who may be unable to use futures, options or swaps, may find it useful to incorporate one of our Boost ETPs as an operationally efficient and cost-effective hedge. Unlike derivatives that can be complex to manage with respect to margin, total risk and exposure management, a Boost ETP allows long only investors to hold a short position.

As ETPs are listed on exchange, they benefit from multiple liquidity providers, full transparency of pricing, TER and swap costs. It is important that investors are cognisant of the more technical features of short and leveraged ETPs such as daily rebalancing, compounding and the over-collateralised swap structure.

Using a 3x Short ETP means that an investor holding €100m in BTPs need only commit €33.3m in the ETP in order to create a fully hedged portfolio. This level of capital efficiency compares favourably to either 1x or 2x Short exposures. Although the portfolio is 100% hedged at the outset as the value of the underlying portfolio and the Short BTP exposure moves the hedge ratio will invariably change. To maintain an appropriately hedged position it is usual to keep the hedge ratio within boundaries such as the +/- 5% from 100% we have chosen in our example.

In terms of the results from using a 3x Short ETP as a hedge, one can see that there was a substantial reduction in risk compared to an unhedged portfolio with annualised volatility falling from 5.5% to 1.8%. With respect to returns, the unhedged portfolio fell by 4.0% over the period, having experienced a maximum drawdown of -4.9%. The fully hedged portfolio, with rebalancing, rose by 1.2% and without rebalancing rose by 1%. The cost of putting on the hedge and maintaining a rebalanced hedge was estimated at 8.55bps reflecting the five hedge ratio rebalance trades.

Figure 2: A fully hedged portfolio manages risk



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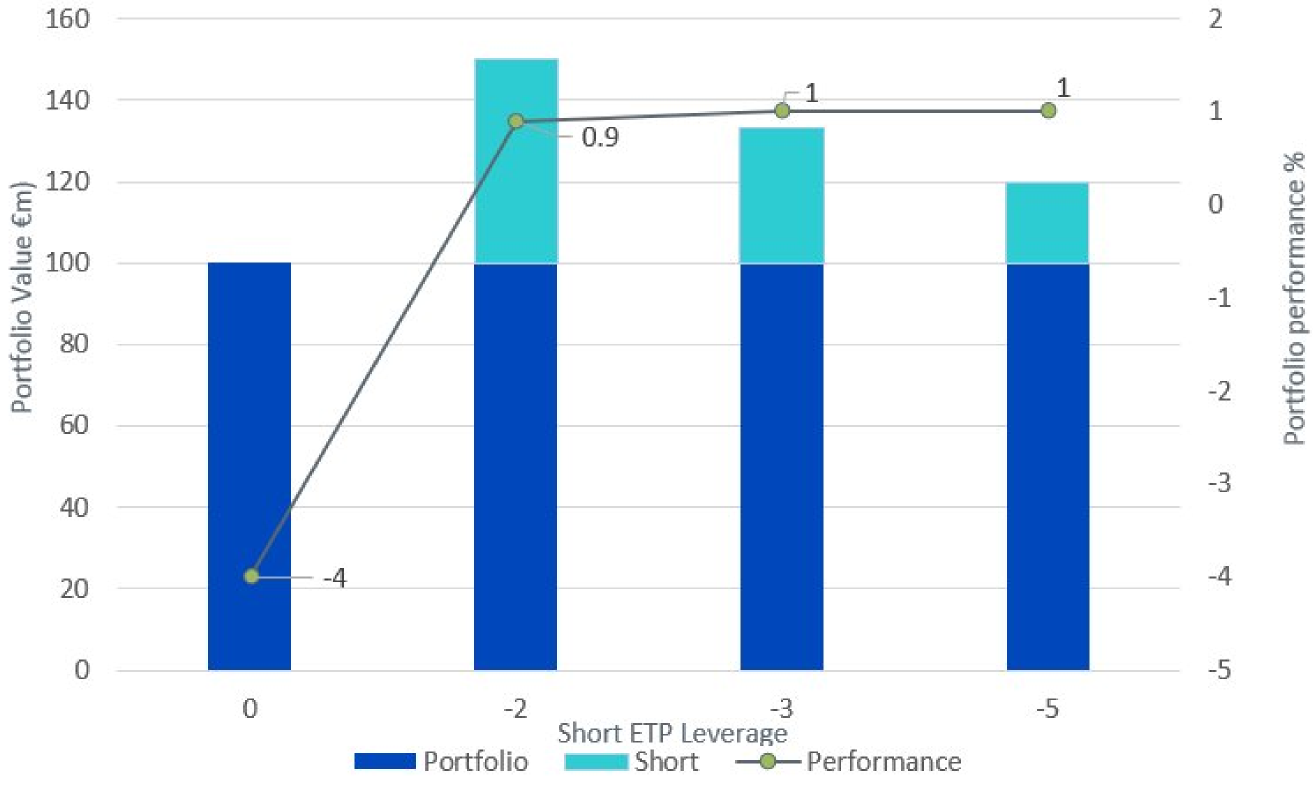
Period: 3 October 2016 to 06 December 2016.
Sources: WisdomTree, Bloomberg. The value of an investment in ETPs may go down as well as up and past performance is not indicative of future returns.

Investors also have the ability to use short ETPs with higher levels of leverage which are even more capital efficient in the context of the total portfolio. Consider again the €100m portfolio, using a -2x ETP requires a position of €50m to provide a fully hedged portfolio. Using a -3x ETP reduces this to €33.3m whilst using a -5x ETP provides for even greater capital efficiency requiring only €20m to deliver a fully hedged portfolio. A higher leverage factor may require more frequent rebalancing but it is also possible to widen the rebalance parameters and still achieve an efficient hedge. Over the same period we have analysed a -5x ETP which would have delivered a similar portfolio hedge but with much greater capital efficiency. At a portfolio level, using a higher leverage ETP does not imply higher overall risk as shown by the portfolio volatility.

Figure 3: Portfolio capital efficiency and performance



Source: WisdomTree

Boost short fixed income ETPs provide an operationally and capital efficient means of protecting fixed income portfolios. Investors with substantial domestic government bond holdings can potentially benefit from hedging using ETPs on BTPs, Bunds and Gilts. In an environment where the ECB is likely to unwind quantitative easing and with the potential for modest rises in interest rates, hedging strategies for fixed income portfolios are likely to become increasingly useful. BTPs are also likely to come into focus based on political risk ahead of next year's expected Italian elections.

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