How to manage BTP risk ahead of the Italian election

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The upcoming Italian election, scheduled for 4 March 2018, has the potential to revive a risky environment for Italy government bonds, BTPs. Whilst not entirely reminiscent of the 2016 referendum, which highlighted significant constitutional issues and challenges, the election certainly brings an element of uncertainty that investors may do well to prepare against. Historically BTP yields have proven to be sensitive to political risk and in the run up to the referendum in 2016, yields jumped dramatically from 1% to 2%.

In the recent upward move in yields, in December 2017, ahead of the dissolution of the Italian parliament, the 10 year BTP yield increased from 1.39% to 1.77%, a modest shift of 0.38%. Although this election is unlikely to result in the scale of change expected ahead of the 2016 referendum, it may well prove to be eventful. Risks range from not having a clear winner, a win by the anti-establishment Five Star Movement and the possibility of a coalition between Forza Italia and the Northern League or other centre-right parties.

Chart 1: The recent rise in BTP yields

Source: Bloomberg

Ahead of the election we believe that investors may wish to hedge their exposure to BTPs through tactically allocating to leveraged short ETPs. Apart from managing political risk there is also an increasing focus on the risks associated with rising rates in Europe as the ECB unwinds the current benign Quantitative Easing environment.

Hedging ahead of the 2016 referendum

In order to examine the effectiveness of using leveraged short ETPs as a hedging tool we have examined the period in the run up to Italy's 2016 referendum from 3 October to 6 December 2016. The benchmark that we have used to represent typical broad BTP portfolios is the FTSE MTS Ex-Bank of Italy BTP index. Over the period, at its worst it had declined by 4.9%, although it staged a modest recovery to end down 4% after the election results by 6 December 2016.

Investors looking to hedge portfolios are not only seeking to protect the capital value of the assets in question but are also concerned with managing the volatility of the overall portfolio. For those investors, unable to implement strategies using futures, options or swaps, ETPs may provide an operationally efficient and cost-effective hedge.

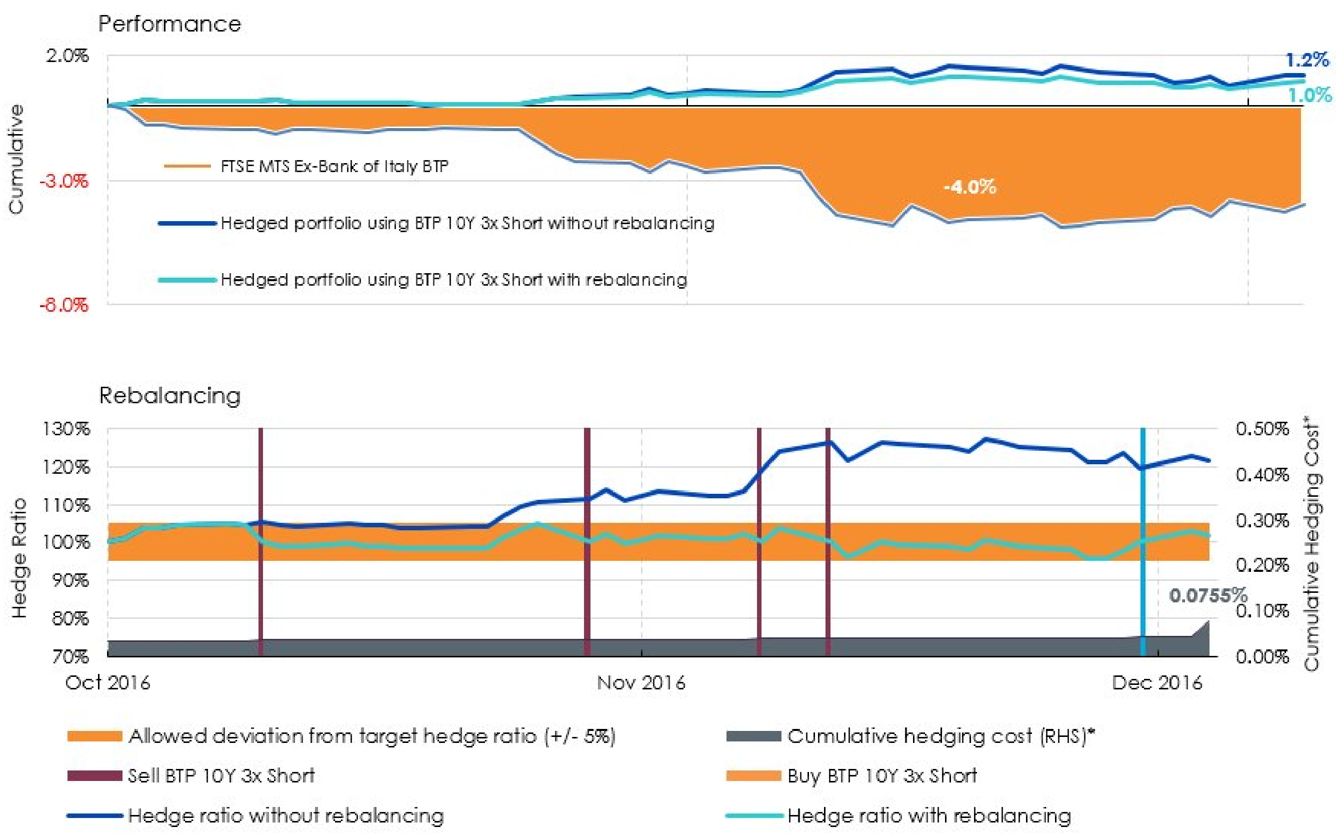
In contrast to derivates that can be complex to manage with respect to margin, total risk and exposure management, ETPs allows long only investors to hold a short position. As ETPs are listed and traded on exchange, they benefit from the availability of multiple liquidity providers, full transparency of pricing, TER and swap costs. It is important that investors are fully appraised of the more technical features of short and leveraged ETPs such as compounded returns, daily rebalancing and the over-collateralised nature of the swap.

Using a 3x short ETP to manage risk

An important aspect of using a 3x short ETP is that an investor holding €100m in BTPs need only allocate €33.3m in the ETP in order to create a fully hedged portfolio. This is an extremely capital efficient proposition compared to using either 1x or 2x short exposures. In the hedging example below the portfolio is 100% hedged at the outset. As the underlying portfolio and the short BTP exposure change in value over time then the hedge ratio will naturally evolve and deviate from 100%. To maintain an appropriately hedged position we have used boundaries at the +/- 5% level as the rebalance threshold.

The portfolio benefits from using a 3x short ETP as a hedge are demonstrable with a substantial reduction in risk compared to an unhedged portfolio, with annualised volatility falling from 5.5% to 1.8%. The return profile of the hedged portfolio is also considerably altered. The unhedged portfolio fell by 4.0% over the period, having had experienced a maximum drawdown of -4.9%. The fully hedged portfolio, with rebalancing, rose by 1% and without rebalancing rose by 1.2%. The cost of putting on the hedge and maintaining a rebalanced hedge was estimated at 8.55bps, reflecting the five hedge ratio rebalance trades.

Chart 2: The benefits of hedging BTPs and rebalancing the hedged portfolio

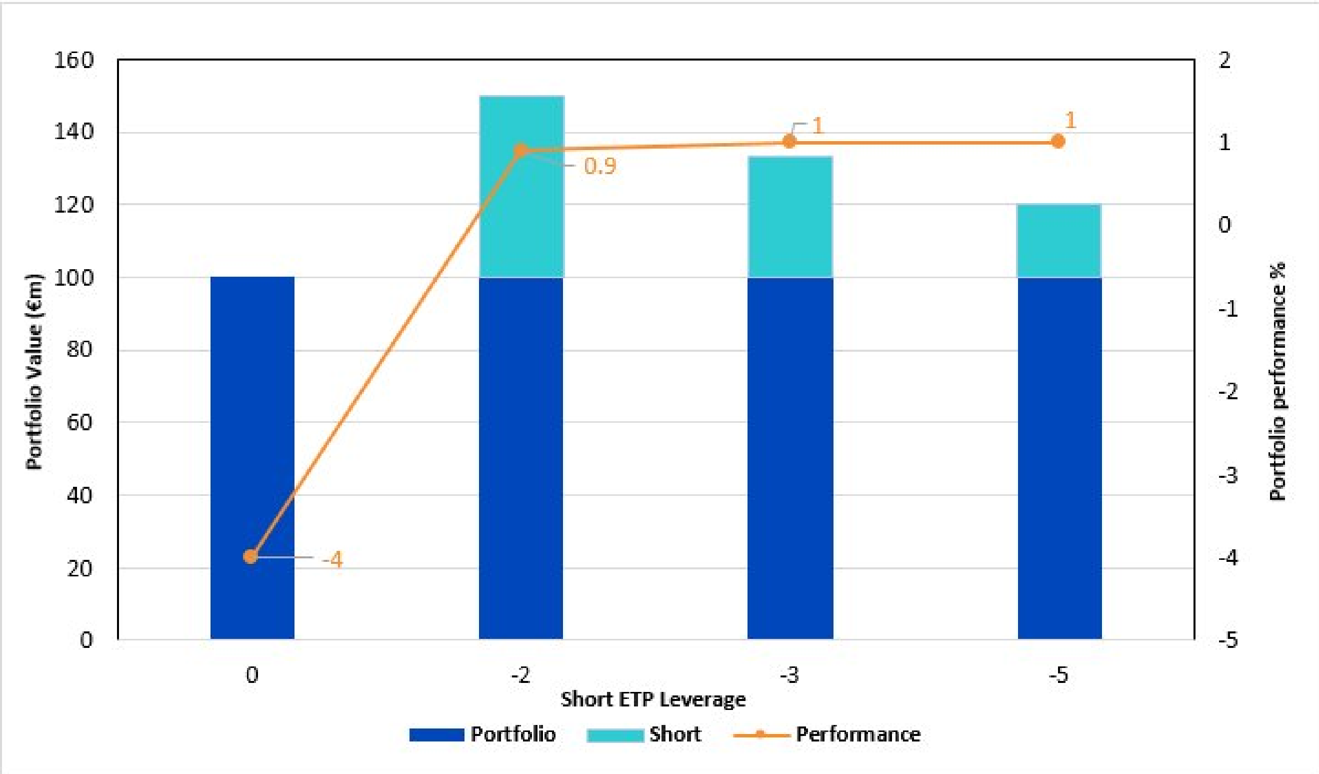


Source: WisdomTree

Achieving greater capital efficiency

At a portfolio level, investors can use short ETPs with higher levels of leverage to benefit from greater capital efficiency without compromising on overall volatility and risk. Consider the same portfolio benchmarked to the FTSE MTS Ex-Bank of Italy BTP index, using a -2x ETP requires a position of €50m to initiate a fully hedged portfolio. As shown in our example, a -3x ETP reduces this requirement to €33m whilst using a -5x ETP reduces this even further to only €20m whilst delivering an equivalent hedge, albeit one that is even more capital efficient. As shown by the example of the 3x Short ETP, using higher leverage does not result in higher overall risk at a portfolio level.

Chart 3: Portfolio capital efficiency and performance



Source: WisdomTree

Managing fixed income portfolios around event risk such as Italy's upcoming elections, could be ideally suited to using short fixed income ETPs. In the case of BTPs and the forthcoming Italian election hedging portfolios using short BTP ETPs can be both capital efficient and beneficial to overall risk and return characteristics. As the ECB begins to unwind the current Quantitative Easing environment higher rates may pervade across Eurozone sovereign debt creating hedging opportunities not just in BTPs but also Bunds.

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