WHY ALLOCATING TO CASH MAY NOT BE THE BEST STRATEGY

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A vast majority of investor portfolios that we work with are allocated strategically anywhere from 1%-10% in cash. Quite often the objective for this strategic cash allocation is to disinvest a fraction of portfolio beta and therefore reduce overall volatility. Allocations to cash make sense–particularly to fund spending requirements over the short-term – but of course the greater defensive positions, the less potential upside participation one can get as well.

What if there were asset-allocation strategies that potentially reduced volatility but still participated on the upside?

In May 2018, WisdomTree launched a strategy that tracks Cboe’s S&P 500 PutWrite Index (PUT within the charts of this piece and throughout). The strategy is designed to collect premiums by selling cash collateralise S&P 500 put options every month. When complemented with an equity portfolio, it can reduce portfolio beta and provide higher risk-adjusted returns.

My analysis below considers how an allocation to the PUT strategy could be an alternative to cash or short duration fixed income, with the aim to attain higher upside participation while managing volatility in a way that looks similar to allocations to cash and equities. With the Cboe S&P 500 PutWrite Index now having more than 10 Years of live track record, we now have comfort of analysing results backed by a longer period of time.

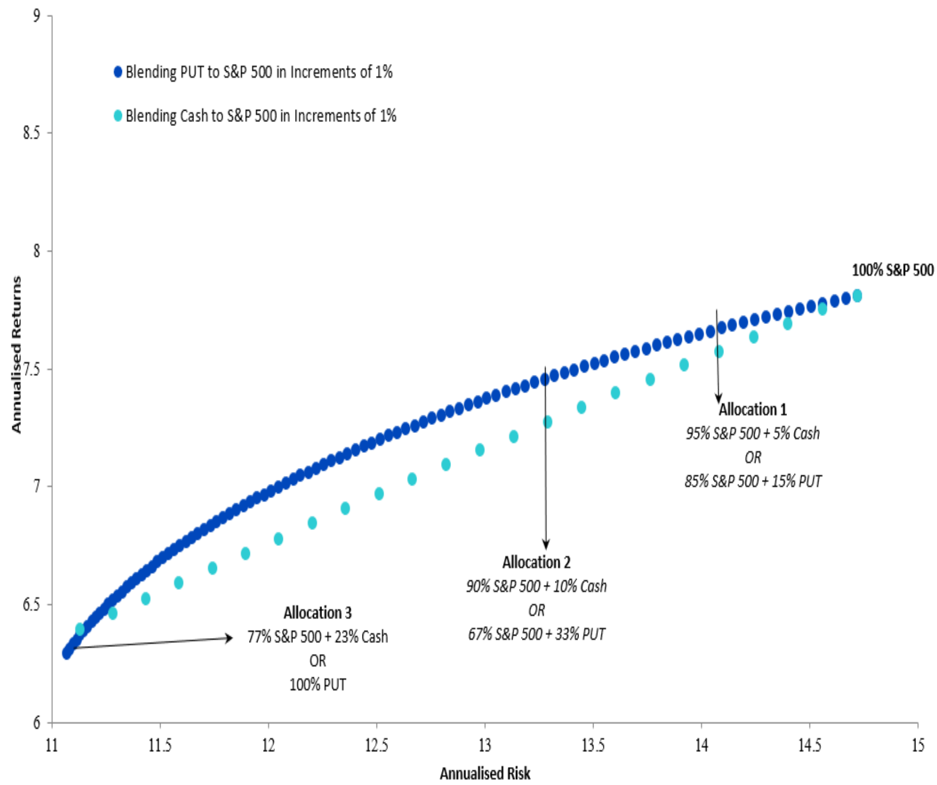
The Cboe S&P 500 PutWrite Index – measuring risk reduction properties by comparing to S&P 500 and cash blends

In the chart below, we are starting with a simulated 100% allocation to the S&P 500 (i.e. Portfolio A, top right) and then either blending cash (lower line) or the Cboe S&P 500 PutWrite Index (upper curve) in increments of 1%. What we see is that for every cash allocation, investors could have improved their total returns by migrating to the Cboe S&P 500 PutWrite Index curve or in other words by allocating to this index instead of blending the S&P 500 with cash.

An investor allocating 5% to cash could have achieved similar volatility with higher returns by allocating 15% in the Cboe S&P 500 PutWrite Index. Similarly, a couple of other key cash allocation and corresponding Cboe S&P 500 PutWrite Index allocations are below (PUT refers to the Cboe S&P 500 PutWrite Index):

- Portfolio A: 100% S&P 500
- Portfolio B: 5% allocation to Cash / 95% to S&P 500 had similar risk as 15% allocation to PUT/85% Allocation to S&P 500
- Portfolio C: 10% allocation to Cash / 90% S&P 500 had similar risk as 33% PUT / 67% S&P 500
- Portfolio D: 23% allocation to Cash/77% S&P 500 had similar risk as 100% PUT

Figure 1: Simulation: allocating to PUT offered better risk/reward than cash for equity investors (30 June 2007 to 30 June 2018)



Source: Bloomberg. Period is from 30 June 2007 to 30 June 2018. PUT refers to the Cboe S&P 500 PutWrite Index.

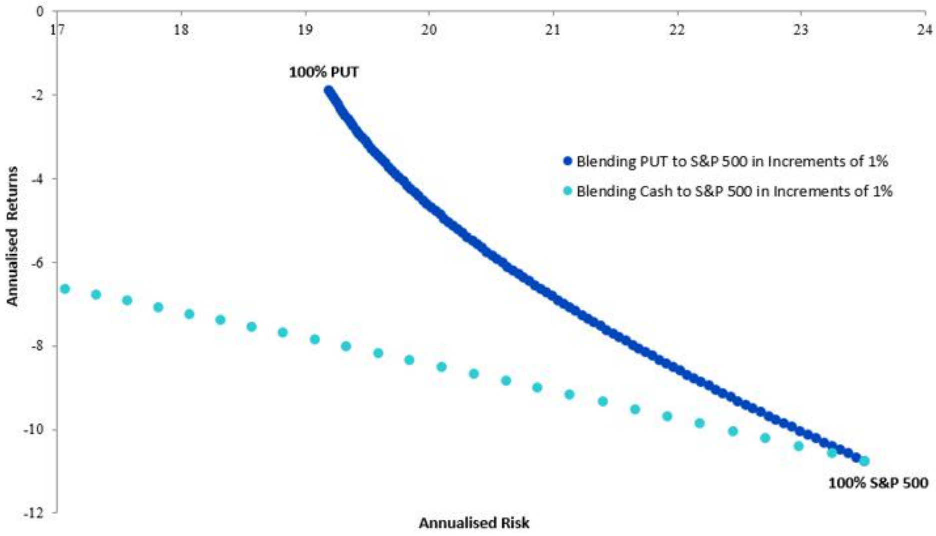
You cannot invest directly within an Index. Historical performance is not an indication of future performance and any investments may go down in value.

In these hypothetical scenarios, different investors could have attained similar risk characteristics with better returns by allocating a different proportion of equity allocations to the Cboe S&P 500 PutWrite Index. In addition, no matter what proportion was allocated to this index, it would have historically always had better returns than any combination of S&P and Cash.

What Happens on the Downside?

So far so good, however investors keep cash to protect downside, but unless these Cboe S&P 500 PutWrite Index blends do well on the downside they are not a true match to cash allocations. The chart below zooms into a specific two-year period of between January of 2008 and December of 2009, i.e. the peak of financial crisis. During this time, S&P 500 lost over 20% of its value.

Figure 2: PUT provided better risk/reward during stress times



Source: Bloomberg. Period is from 31 December 2007 to 31 December 2009. PUT refers to the Cboe S&P 500 PutWrite Index.

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Summarising risk-return of blends above

In the table below, we quantify and compare our key hypothetical portfolios above for overall period as well as for the period zooming over financial crisis. Not only would the Cboe S&P 500 PutWrite Index alternative have better returns for the entire period; it would also out-perform its cash peer during stress times.

For example, simulated portfolio C with 10% Cash/90% S&P 500 or 35% PUT/65% S&P 500

- Overall Period – PUT alternative outperforms by 31 bps1 annualised with very similar risk.
- Financial Crisis – PUT alternative outperforms by 142 bps1 annualised with slightly higher risk.

Figure 3: summarising risk-return of key blends from figures 1 & 2

		Overall Period 30/06/2007 - 30/06/2018		Financial Crisis 31/12/2007 - 31/12/2009	
		Annualised Ret. (%)	Annualised Risk (%)	Annualised Ret. (%)	Annualised Risk (%)
	100% S& P 500	7.82	14.7	-10.74	23.51
Allocation 1	95% S&P 500 + 5% Cash	7.52	13.9	-9.84	22.18
	85% S&P 500 + 15% PUT	7.64	13.9	-9.39	22.55
Allocation 2	90% S&P 500 + 10% Cash	7.22	13.1	-8.98	20.87
	67% S&P 500 + 33% PUT	7.41	13.1	-7.78	21.53
Allocation 3	77% S&P 500 + 23% Cash	6.40	11.1	-6.91	17.56
	100% PUT	6.30	11.1	-1.86	19.18

Source: Bloomberg. Periods are specified within chart. PUT refers to the Cboe S&P 500 PutWrite Index.

You cannot invest directly within an Index. Simulated annualised returns are not inclusive of fees. Historical performance is not an indication of future performance and any investments may go down in value.

Conclusion

Blending the Cboe S&P 500 PutWrite Index in can potentially produce results from a risk reduction standpoint similar to allocating a portion of equities to cash. However, when one usually allocates to cash, they lose upside participation in the market. Utilizing the Cboe S&P 500 PutWrite Index would have historically provided a better risk and return experience.

WisdomTree's PutWrite Strategy Fund (PUTW) tracks the Cboe S&P 500 PutWrite Index which now has more than 10 years of live track record. PUTW is a way for investors to gain access to Cboe S&P 500 PutWrite Index which as we demonstrated above has the ability to offset a decline in the value of the S&P 500 to the extent of the premiums received. From an asset allocation perspective, blending PUTW with an equity portfolio could not only lead to an overall lower beta, but unlike cash will also participate on the upside, potentially offer investors an alternative for a Cash allocation- like volatility with higher returns.

[1] Simulated annualised returns are not inclusive of fees.

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