

Opalesque Exclusive: Investors seeking downside volatility management strategies anticipating eventual market drops – Sherpa Asset Management

Friday, March 04, 2011

From Kirsten Bischoff, Opalesque New York:

Vancouver-based [Sherpa Asset Management](#) views the June 2008 launch of the firm's Sherpa Diversified Returns Fund as "fortunate timing in hindsight" even though they took the equity long/short fund out into the most volatile equity markets in recent history. By the end of the first year of operations the fund returned -5.96% compared to the fund's benchmark the S&P 500, which was down -34.37%, and in the two years of recovery from the financial crisis the firm has posted +19.72% in 2009 and +12.15% in 2010.

As a result of delivering on their promise to run a strategy focused on North American large-cap equities, utilizing a proprietary options trading strategy to build in a protective hedging feature, Sherpa has not seen any redemptions since their launch, and has since launched a second fund. "The fund is well 'on model', meaning it has delivered on its objectives," Sherpa's David Guarasci told Opalesque. The fund was recently awarded a mandate from a well-respected Canadian pension plan, which Guarasci says is largely due to the well-defined process the firm uses to lower volatility to provide a protected equity profile.

"Everyone knows that they have to be invested in the equity markets, but they also know that eventually there will be another market drop," he says. "That will happen again in the next five to ten years, or maybe sooner. No one wants to stomach that again and accordingly investors are seeking downside volatility management strategies."

The team's options strategy is always built into the portfolio, which means that the fund looks to generate yield and provide layers of downside protection at all times. "In the last bull run we haven't needed the protective component of the options overlay, so it has been a lot of work for nothing. But the point is, we don't know when the next down market situation is going to happen, so we're always prepared for it," says Guarasci.

That sense of protection is doubly enticing to institutional investors who even more than a bear market, worry about continued volatility. This was witnessed in 2010, especially with the flash crash in May. As an example of Sherpa's ability to manage volatility during this period, the protected beta fund posted returns of 2.81% to the end of August vs S&P500 returns of -5.90%.

The firm's second fund (The Sherpa Market Neutral Income Fund), which works to dial all beta out of returns, entered the still jittery markets in June 2010 and ended the year at +7.21%. That fund was recently awarded a commitment of \$160m from several institutional investors. "The market neutral fund has been attractive to investors because we are using options for two things – to generate yield and for protection. We have an engine generating the yield and then we put a reasonable portion of that yield into protective strategies," Guarasci explains. "The portfolio starts with a net flat exposure, and through the yield structure we expect it to generate 8%-10% annual returns. I compare it to fixed income products because it just trickles in 50-100bps a month."

If Guarasci has any advice for funds launching post-financial crisis it is to deliver what you promise your investors from day one. "Where the traction [of asset growth] has come in is that investors now understand that there is a very good chance we will continue to deliver what we say we will deliver. We couldn't have asked for better stress conditions than 2008 and 2009 and even 2010 was a difficult year." Downside volatility management may be one of the things investors claim to want above all else, but that doesn't necessarily mean they are willing to pay for it. The financial shocks of the global crisis likely went a long way in proving the worth of strategies such as Sherpa's.

Explaining to clients and potential clients exactly what the firm's strategy entails is one of the most important aspects of what the firm does. "A lot of people do not want to invest in something that they don't understand, which is why the bulk of the world has their assets in long-only products," Guarasci says. Our biggest challenge is getting investors to understand the product. But a large part of that success comes from the pedigree of our team and the fact that underneath the hood is a very disciplined process."

This article was published on Opalesque and can be accessed here:

http://www.opalesque.com/62956/Investors_seeking_downside_volatility_management_strategies_anticipating956.html