GETTING THE BIG ONE RIGHT

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For much of 2014 markets were somewhat tamed by central banks. We essentially found ourselves in a low-volatility, low-volume and low-conviction bull market as a potent combination of accommodative monetary policy and forward guidance achieved one of their primary goals; market stability.

The FTSE World Index has grown impressively and the S&P© 500 Index has tripled since the depths of the financial crisis and sovereign bond spreads have collapsed well beyond pre-crisis levels. The Chicago Board Options Exchange Market Volatility Index® (VIX) — a measure of equity volatility — has been low since the start of 2012.

THE DANGERS OF COMPLACENCY

The blip in late October 2014 may well have given some investors pause for thought but for some time now we have asked: Are investors conditioned to a low volatility environment and possibly too complacent?

Low volatility combined with the need for higher yield has driven investors further up the risk spectrum and complacency could ultimately spell trouble for many and precipitate the next market correction.

And it is not just US equity volatility that has been low — European equity, interest rate and foreign exchange volatility levels are also at near-decade lows.

WHAT COULD GO WRONG?

Volatility is driven by uncertainty and — through coordinated monetary policy, together with bond purchases and more recently forward guidance — uncertainty has indeed been extraordinarily low. However, we expect volatility to rise as the advanced economies follow increasingly divergent paths with their monetary policy.

The US and UK are already deliberating on their tightening paths, whereas the European Central Bank is only now implementing quantitative easing. This could well be enough to force volatility from its subdued state, but there are other risks on the horizon that could cause a more sudden rise.

CONSIDERING THE RISK SIGNALS

Market Performance

Reflecting on last year's market performance and considering traditional valuation metrics, there is indeed cause to pause and take stock. And it is not just recent market performance that suggests caution. As well as the VIX other risk metrics, such as the Merrill Option Volatility Estimate Index — a measure of bond market volatility — have fallen to very low levels not seen since 2007, prior to the global financial crisis.

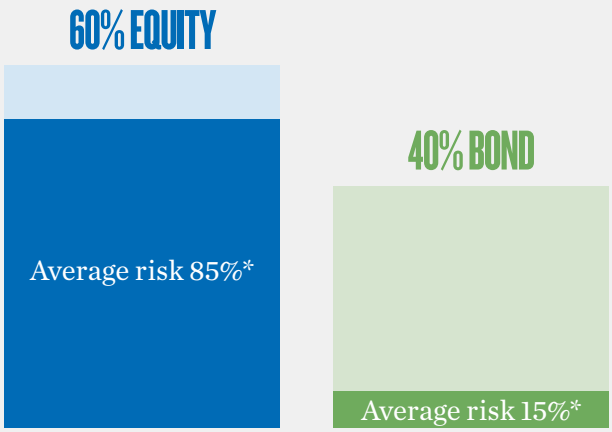
Market Regime

SSGA's in-house Market Regime Indicator, which uses a mix of inputs, such as equity and currency volatility and bond spreads to monitor market conditions, spent most of last year indicating very low risk, before moving sharply into High Risk in October, a portent, perhaps, of things to come.

KNOW WHERE YOUR RISK LIES

Equity Risk Dominates the Traditional 60/40 Balanced Portfolio

This means that the true portfolio risk is highly concentrated and highly correlated. It also means that investors may not be realising the true level of protection they require.



*Based on a rolling 5-year risk allocation of a 60% Equity / 40% Bond portfolio average spanning 1981-2012. Source: SSGA. As of 28 November 2014. For illustrative purposes only.

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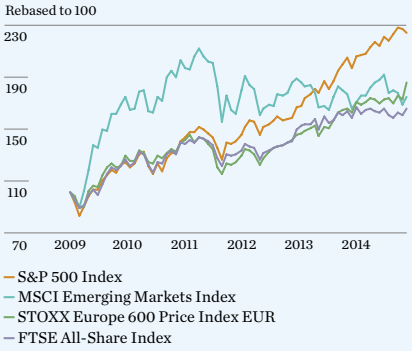
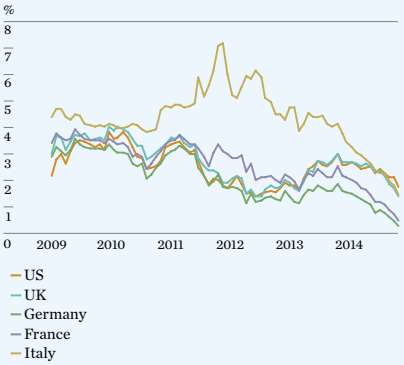
Equity Indices at All-Time Highs



Bond Yields at All-Time Lows



Source: Bloomberg Finance LP. As of 27 January 2015. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

Fundamentals

Fundamentals may also present potential pitfalls. From eurozone concerns to geopolitical issues in Ukraine or the Middle East, spats between China, Vietnam and Japan are causing concern, and China's shadow banking sector also casts a pall.

But be realistic about the effect of geopolitical risks — SSGA has researched their impact and found that they may not have the lasting long-term effects that many ascribe to them. However, many investors cannot bear even short-lived losses and avoiding or severely limiting them makes sense in terms of time to recovery. In any case, market-based events can and typically do affect portfolios deeply and broadly over the long term. The right protection strategy should help defend against both types of risk.

WHEN TO START, WHAT TO DO?

Although we note the risks that stem from high valuations and the propensity for geopolitical instability to change the investment landscape, we also recognise in our conversations with clients that there is a concern that adopting a 'defensive' stance risks missing continued upside potential. This is particularly the case against a backdrop of ultra-low interest rates and Quantitative Easing (QE).

GETTING THE BALANCE RIGHT

However, we believe that there are ways to optimise the balance of needs through a variety of overlay and direct investment strategies. In particular, investors could consider a Target Volatility Trigger (TVT) framework, which seeks to provide downside protection and yet leaves potential for upside participation; or asset allocation strategies which dynamically allocate according to the prevailing market conditions, and can be a good way to help provide downside protection and potential alpha generation. Overlay programs using listed futures and options to create put-spread or put-spread collar strategies have also historically provided downside protection.

TIMING IS CRITICAL

Aggressive de-risking can prove costly should the markets continue to rise, and yet a 'defensive' stance risks missing continued upside potential, particularly against the backdrop of ultra-low interest rates and QE. In light of this, we believe that implementing downside risk protection while costs are low may make sense. Our experience has been that it is always better to start implementing portfolio protection decisions when others are greedy, when there is time to consider alternatives and also when the cost of implementing these decisions is low. When markets are in crisis mode — as they were in September 2008 and August 2011 — it is often, quite simply, too late.

WAYS TO TACKLE EQUITY RISK

Target Volatility Triggers

Can provide a stable volatility level in the portfolio.

Market Regime Aware Investing

Via Dynamic Asset Allocation Funds.

Derivatives Overlays

Option-based overlays and volatility futures.

Alternative Strategies

Liquid alternatives, such as Managed Futures and Global Macro and advanced beta equities, such as Managed Volatility.