# Academy Insight

## Continuing the series of monthly columns designed to educate readers on cutting-edge ideas, RBS discusses how this tumultuous year frightened investors and why intelligently structured products offer a brighter investing future

> It is understandable why investors are hoarding record amounts of cash at present. The Standard and Poor's 500 has recorded its highest 12-month volatility since 1934, emerging markets have been pulverised, showing decoupling to be a myth, and hedge funds have underperformed and, in many cases, indefinitely suspended redemptions. To many, investing has been a lot more about pain than gain this year. However, following the carnage in financial markets, many investment opportunities have arisen for discerning investors.

Selective fundamental valuations seem very compelling. Investors looking to gain emerging markets exposure can now buy on attractive multiples, with some high-quality Chinese companies for example trading at below eight-times forward earnings. Many believe convertible bonds (CBs) are looking very attractive, too. Following the disequilibrium created after many hedge funds became forced sellers, CB prices have been driven artificially low. In fact, many CBs are paying substantially above Libor, even after a credit default swap is purchased to hedge the credit risk.

Property has been one of the hardest hit sectors. The Tokyo Stock Exchange REIT, an index of Japanese property companies, is down over 70% from peak valuation and can now be bought at levels lower than this index has ever recorded. With a forward implied dividend yield 6% above the local funding rate, this presents an attractive substitute carry trade or opportunity to purchase the index at a large forward discount. Even the House Price Index, the benchmark UK residential property index, can be bought three years forward at a 30% discount to the spot price, which may be of interest to contrarian investors.

The recent price declines present an opportunity to reassess longer-term views that, for the past few years, had been hailed 'a sure thing'. One obvious example is commodities. Oil peaked at nearly $150 per barrel and now trades at one third of that level. Oil companies stock prices have held up much better than the broader market, but are currently trading on around five-times forward earnings with record dividend yields. Oil stocks also present opportunity for call over writing, given the high levels of implied volatility, and hence rich option premia in this sector. Then of course there are many investors looking for a major recovery in the global banking sector. Banks are being recapitalised and repositioning themselves to be leaner and more cost focused as they embrace tougher times ahead. Finally, one cannot help but notice that longer-dated implied volatilities, even on the major benchmarks, remain historically very high. This presents opportunity for longer-dated structured products to sell embedded puts. Guaranteed annual income can then be paid substantially above the base rate, while the underlying index, hopefully, at least stabilises or modestly appreciates over the longer term.

In the structured products landscape investors are shunning complex payouts and looking for genuine value add. One example is volatility stabilised products. Capital protected volatility stabilised products can be linked to indices or thematic stock baskets and are attractive because the level of volatility is set and known in advance. Volatility stabilisation is achieved by dynamically managing participation; implementing low participation in times of high volatility and higher participation in less volatile times. In recent markets, and in most bear markets in history, this has led volatility stabilised products to achieve lower risk than traditional investments and also earn substantially more return. Volatility stabilised options will often be much cheaper than regular options, providing the investor with a higher level of capital protection or other valuable customised features.

Looking ahead, investors are set to continue embracing dynamic strategies as an investment opportunity to earn absolute returns regardless of uncertain market direction. These strategies can effectively be rule-based implementations of sophisticated trading strategies that were traditionally reserved for hedge funds. Dynamic strategies may include: forecasting/prediction models; equity long-short; pair trading; momentum trading; mean reversion; commodity curve arbitrage; yield curve arbitrage; and rule-based allocation in a multi-asset allocation framework. Compared to hedge fund investments, dynamic strategies offer: superior liquidity; the ability to create capital protection on individual strategies; lower volatility (where volatility stabilisation can be used in conjunction with a dynamic strategy) and more transparency. Even during this year, with live track records, cleverly constructed dynamic strategies have provided excellent returns and low volatility to smart investors.

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