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ICON

DYNAMIC HEDGING:
ADJUSTING MARKET EXPOSURE BASED ON VALUATIONS

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We believe that leading up to the financial crisis of 2008, investors generally thought risk aversion and volatility avoidance was a thing of the past. Indeed, Federal Reserve governors came to define the time period from the mid-1980s until 2007 as the "Great Moderation" due to the relatively benign economic environment. However, 2008 brought on significant economic volatility, investment losses, and the reemergence of risk consciousness within the investment landscape. We believe the volatility and investment losses led to increased risk awareness, which, in turn, brought about large demand for products that offer both reduced participation in falling market environments and decreased exposure to market volatility. It appears that investors have embraced these low volatility strategies with open arms, pouring billions of dollars into this asset class.

We believe many of the current low volatility strategies tend to focus primarily on downside mitigation, which may lead to a reduction in upside potential. In an attempt to address this scenario, this paper will focus on a broad concept referred to as Dynamic Hedging. At its most basic level, our variation of Dynamic Hedging adjusts equity market exposure based on valuations and focuses on achieving four key goals:

1. Hedge decision based on equity market valuations.
2. Mitigate the effects of market volatility.
3. Participate in equity market upside.
4. Reduce hedging costs due to variable market exposure.

> *"**Higher Risk-Adjusted Returns.** The Options-Based Funds had similar returns as the S&P 500® Index with lower volatility and lower maximum drawdowns. The Options-Based Funds had higher risk-adjusted returns, as measured by the Sharpe Ratio, Sortino Ratio, and Stutzer Index."*
>
> *– Keith Black and Edward Szado[1]*

In this paper, we highlight what we believe are several common types of low volatility investing strategies along with the risks associated with each. Next, we define ICON's version of Dynamic Hedging and how we believe this approach can be useful in this space.

BACKGROUND

As mentioned above, we have seen investors pour money into low volatility strategies over the last couple of years and a recent study, "Performance Analysis of Options-Based Equity Mutual Funds, CEFs, and ETFs," authored by Keith Black and Edward Szado and sponsored by the Chicago Board Options Exchange (CBOE), highlighted not only the growing popularity of reduced volatility strategies but also the potential benefits of low volatility strategies. One portion of the study focused on three specific risk adjusted return statistics – *Sharpe Ratio*, *Stutzer Index* and *Sortino Ratio*.

After analyzing these risk adjusted return statistics, Black and Szado concluded that a collection of options based-strategies produced higher risk-adjusted returns than the S&P 500 Index with lower volatility over the 2000-2014 time period.

TYPES OF LOW VOLATILITY STRATEGIES

There are a wide range of different methodologies that can be used to hedge market based exposure and volatility. These different methodologies vary in ways too numerous to address here, but for ease of discussion we've categorized them into three broad groups– Asset Class Exposure, Portfolio Optimization, and Option/ Future Hedging.

[1]"*Performance Analysis of Options-Based Equity Mutual Funds, CEFs, and ETFs," January 31, 2015. Available at http://www.ingarm.org/public/articles and http://www.cboe.com/micro/buywrite/performance-options-based-funds.pdf.*

STRATEGY	DEFINITION	LOW VOLATILITY METHODOLOGY	RISKS
Asset Class Exposure	We define Asset Class Exposure strategies as those that tend to either maintain strict exposure to various asset classes or vary asset class exposure based on specific data points or variables. Historically this has been the most predominant approach.	Volatility minimization based on historical correlations of asset classes and specific market environment.	Asset class behaves in a manner not explained by historical data. Emergence of new market environment.
Portfolio Optimization	These strategies generally utilize computer calculations and simulations to build a portfolio aimed at achieving the highest amount of return for an acceptable level of risk.	Volatility minimization largely based on historical statistical relationships that are forecasted into the future.	Holdings behave in a manner that is not explained by historical data points. Additionally, at times these types of strategies can have significant sector specific exposure that can expose investors to concentration risk.
Option/ Future Hedging	These strategies utilize either option or futures contracts to minimize stock specific or market based volatility exposure and hedge various factors.	Utilization of option or futures contracts to create hedging profiles that offset market movements during volatile environments.	Volatility minimization can limit upside participation specifically if hedges are static or volatility targeting strategies are utilized. Additionally, imperfect hedges can introduce basis risk where the underlying asset moves differently than the hedging tool utilized.

All three of these strategies may prove to be useful during specific market environments. However, we believe the specific focus on volatility reduction could hamper potential upside returns.

DYNAMIC HEDGING: DEFINITION AND IMPLEMENTATION

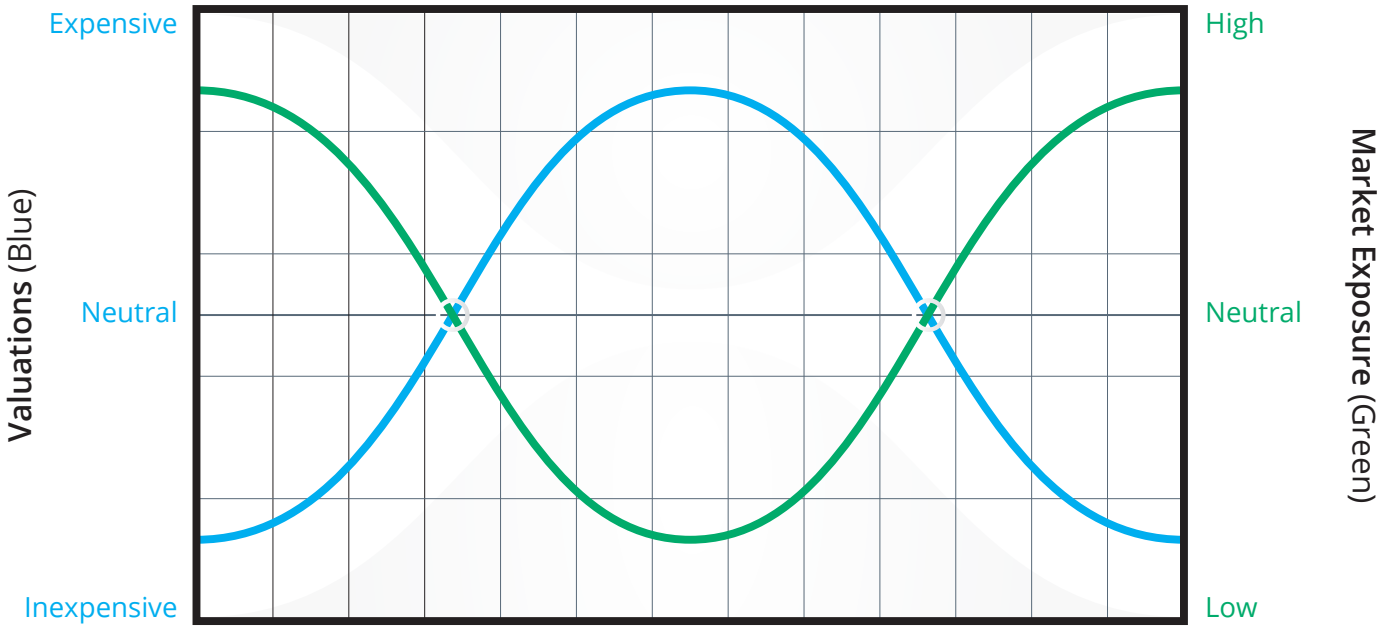
While the strategies above can decrease overall volatility, they may also be contingent on specific market environments or historical mathematical assumptions regarding asset correlation. Additionally, to the extent a strategy focuses solely on mitigating the effects of market volatility, it may hinder its ability to participate in market rallies. When investment calculations and liability management are contingent on specific return assumptions, a decreased ability to participate in market advances may put long term investment goals out of reach. Our version of Dynamic Hedging not only aims to reduce the effects of market based volatility during times of stress but also provide the potential to capitalize on equity market upside when we believe the opportunity presents itself.

When discussing our version of Dynamic Hedging we believe it is important to separate ***upside*** volatility, which we are willing to accept, from ***downside*** volatility, which we aim to avoid. As part of our evaluation of risks in the market, we focus on our proprietary equity market valuation methodology to help dictate when we should look to maximize market exposure and when we should attempt to mitigate the effects of market volatility. More specifically, market based exposure is increased when equity valuations are attractive and inexpensive according to our methodology as we attempt to capture the value our system indicates.

On the other hand, market based exposure is reduced when our methodology indicates that equity market valuations are unattractive and expensive as we attempt to mitigate the effects of downside market volatility.

The graph below provides a simplified hypothetical illustration of these movements. Of course, no strategy will be ideal in every market and each strategy has unique risks which should be considered.

VALUATION AND MARKET EXPOSURE



IN CONCLUSION WE BELIEVE:

- Low volatility strategies should be considered as an option in the current market environment.
- To the extent a strategy focuses only on mitigating the effects of market volatility, it may hinder its potential to participate in equity market advances.
- Our version of Dynamic Hedging utilizes our equity valuation methodology as a guide of when to focus on tempering the effects of market volatility and when to adjust equity market exposure in an attempt to participate in equity market advances.

1. Hedge decision based on equity market valuations.
   Our Dynamic Hedging process utilizes our proprietary equity valuation methodology to help guide our exposure to market movements.

2. Aim to mitigate effects of market volatility.
   We believe that when valuations become stretched markets are more at risk for downside moves and tend to be increasingly volatile. We aim to reduce market exposure when our valuation methodology signals valuations are stretched, looking to temper the effects of market volatility.

3. Aim to participate in equity market upside
   We don't focus solely on attempting to reduce volatility. We utilize our version of Dynamic Hedging to adjust our hedging profile during times our system indicates attractive valuations in the equity market, so that we have the potential to participate in the anticipated upside move.

4. Aim to reduce hedging costs due to variable market exposure.
   Hedging strategies can become costly over time. Because our version of Dynamic Hedging varies positions based on our equity market valuations, there may be times when our hedging costs are lower than if we maintained a constant hedge. While this may not succeed in every market, we believe, in general, and over time, the end result is a reduction in average hedging costs.

Past performance does not guarantee future results. *Opinions and forecasts regarding sectors, industries, companies, countries and/or themes, and portfolio composition and holdings, are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.*

Investing in securities involves inherent risks, including the risk that you can lose the value of your investment. There is no assurance that the investment process will consistently lead to successful results. Consider the strategy, investment objectives, risks, charges and expenses of each investment before investing. Options involve certain risks, such as limited gains and lack of liquidity of the underlying securities, and are not suitable for all investors.

Sharpe Ratio: Measure of risk-adjusted performance which calculates the average return in excess of the risk-free rate per unit of volatility.

Stutzer Index: Risk-adjusted return statistic that rewards portfolios with a lower probability of underperforming a benchmark. Adjusts for negative return skew.

Sortino Ratio: A measure of downside risk as the calculation takes the average return in excess of the risk-free rate divided by downside deviation.

ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.

ICON's value-to-price ratio is a ratio of the intrinsic value, as calculated using ICON's proprietary valuation methodology, of a broad range of domestic and international securities within ICON's system as compared to the current market price of those securities. To analyze intrinsic value, the ICON valuation methodology relies on the integrity of publicly released financial statements.

The unmanaged Standard & Poor's (S&P) 500 Index is a market value-weighted index of large-cap common stocks considered representative of the broad market. Total returns for the unmanaged index include the reinvestment of dividends and capital gain distributions but do not reflect deductions for commissions, management fees, and expenses. Individuals cannot invest directly in an index.

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