TD Asset Management

A NEWSLETTER FOR CONSULTANTS

Assets

Summary 2016

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Investing with a Safety Net

A conversation with TDAM's top risk managed strategy specialists.

Jean Masson, Ph.D
Managing Director

Adnann Syed, CFA
Vice President & Director

We recently had an opportunity to sit down with some of TD Asset Management Inc.'s (TDAM) top risk managed strategy specialists to shed some light on how these strategies work and talk about the built in "safety net" within them.

Jean Masson, Ph.D, Managing Director, leads TDAM's quantitative research and development efforts, and manages our team of research professionals. He is involved in the modeling and research of various quantitative strategies including Low Volatility Equities, Enhanced Equities as well as Market Neutral Hedge Funds. Adnann Syed, CFA, Vice president & Director leads TDAM’s Synthetics Portfolio Management team and is one of the lead portfolio managers of the Risk Managed Equity Funds.

What are the Risk Managed Equity Funds?

Adnann Syed: The TD *Emerald* U.S. Risk Managed Equity and TD *Emerald* Global Risk Managed funds ("RME funds") seek to generate capital gains while also providing downside protection. To do this, we (the portfolio managers) employ a two-pronged approach: generating alpha versus the index through an enhanced equity strategy and protecting against downside risk through an equity options strategy that we refer to as the "safety net strategy."

So are the RME funds focused on maximizing return or minimizing risk?

AS: The RME funds seek to provide better risk-adjusted returns than their benchmarks. We aim to generate returns that are similar to those of the benchmark while placing greater emphasis on downside risk protection.

What are the key benefits of the RME funds?

AS: The key benefit is that they offer stable returns across various market regimes. They participate in market gains while also protecting against market declines. As a result, investors are likely to experience returns within a predictable corridor, with much lower realized volatility and lower risk of large losses than if they were holding a traditional long-only equity portfolio.

Can you explain how the enhanced equity strategy works?

Jean Masson: We use a proprietary quantitative approach that seeks to exploit and capitalize on market anomalies that are created by inefficiencies in markets. This approach allows us to seek to add value versus the index while maintaining a similar risk profile to the index. Using our dynamic, adaptive multi-factor model, we rigorously analyze a broad range of securities to determine which have the potential for excess returns, and we hold those securities until the inefficiency dissipates or a more attractive risk/reward opportunity arises.

And what about the downside protection? How did you develop the safety net strategy?

JM: TDAM has been forecasting more muted returns and increased volatility for some time now, so we wanted to find a way to offer our clients opportunities for growth while also managing their downside risk. We reviewed more than two decades of research and came up with three key discoveries that underlie the safety net strategy:

- markets trend upward 2/3 of the time and downward 1/3 of the time,
- properties related to options and volatility change in predictable ways, and
- investor risk aversion makes out-of-the-money options unnecessarily expensive.

Can you briefly describe how the safety net strategy works?

AS: Yes – we take four key steps to create the safety net:

1. First, we buy the benchmark index to gain long equity exposure,
2. Then, we buy longer-dated put options at-the-money to protect against losses.

Together, these two actions can create a well-protected portfolio. However, that comes at a cost. Our research shows that paying for this protection reduces the rate of return substantially. For example, from January 2009-January 2016, the S&P 500 Index generated average annual returns of 12%, but after paying for protection, investors would have been left with a much more modest 3% return. To mitigate this, we take additional steps within the safety net strategy:

3. Sell short-dated call options to generate a premium to offset some of the cost of protection and to participate in upside market moves, and
4. Sell out-of-the-money put options, which are historically needlessly expensive, to generate premiums to further reduce costs.

Selling out-of-the money call options seems counter-intuitive. Could you explain a bit further?

AS: Yes. We've found that consistently selling, rather than buying, expensive protection can deliver a better return experience to investors. Research shows that investors consistently pay a lot more for protection against large losses than history suggests they should. This phenomenon drives up the price of protection so high that it is better to sell the protection rather than to buy it. In this way, we take advantage of higher volatility and make it work for our clients rather than against them.

Do you expect the "safety net strategy" to be useful for a significant period of time, or do you think options will end up being priced differently in the near future, making the strategy less effective?

JM: We believe the safety net strategy will be effective for a long time to come. Our back testing spanned more than 20 years, and showed that we would have been able to successfully exploit the risk premium anomaly over those decades. It's true that we are not the only investors attempting to exploit this anomaly, so it is possible that the excess risk premium could eventually be eliminated. However, we do not believe that will be the case for some time to come; more stringent regulations have actually caused the risk premium to increase as financial institutions are being subjected to more rigorous stress tests, which has led to more demand for these options and driven the risk premium even higher.

Which market environment works best for the RME funds / which environment will be challenging?
JM: In terms of absolute returns, the RME funds should perform very well during a slow, shallow bull market. With respect to relative performance, the funds should outperform notably during sharp downturns, but are likely to underperform during strong upswings due to the fact that some of the upside participation has been sold away with the calls.

Does using the safety net strategy eliminate the potential of the RME funds generating a negative return?

JM: No - both funds have the potential for negative absolute returns during extreme market downturns. However, they are likely to lose less than their equity market benchmarks. For example, our back testing shows that for the period spanning March 1993 to March 2016 (which includes the dot-com bubble burst and the great financial crisis), the maximum drawdown for the TD *Emerald* U.S. Risk Managed Equity fund would have been -10.8%, versus the benchmark's -50.9%.

What other risks are associated with the RME funds?

AS: In addition to the absolute risk we just discussed, there is also what we term relative risk, which stems from the strategy's calculated trade-offs. In order to provide a smoother return profile, we have to make some trade-offs. We sell away some of our upside potential to generate premiums that help to pay for the portfolio protection. This means that the funds' performance may lag relative to their benchmarks, particularly in strong market rallies. However, over the long term, investors should enjoy stable returns with less realized volatility and downside risk.

What is your view on hedging the currency risk in the RME funds?

JM: Our primary focus for all investment decisions, including currency hedging, is improving investors' risk-adjusted return experience. Historically (based on more than 40 years of data), holding a long U.S. dollar position helps Canadian dollar based investors diversify portfolio risk and minimize volatility. This long U.S. dollar exposure can be especially beneficial in a risk-off environment. However, currency hedging can help to mitigate the negative effects of currency moves in the medium term; therefore, we may hedge currency risk if we believe doing so will improve the risk-adjusted return experience for our investors.

You talk about back testing; are the RME funds live yet?
AS: The RME funds were successfully launched in our retail channels in September 2015 and currently have $175 million[1] in AUM. We are waiting for a seed investor before we launch the institutional versions of the RME funds.

What type of investor should consider RME funds?

AS: We believe that the RME funds are particularly well suited for investors who need equity exposure but are concerned about volatility, and investors who have an absolute return focus, such as foundations or endowments.■

[1] Assets under management as of June 3, 2016 for TD Asset Management Inc. and TDAM USA Inc. TD Asset Management operates through TD Asset Management Inc. in Canada and through TDAM USA Inc. in the United States. Both are wholly-owned subsidiaries of The Toronto-Dominion Bank.

Industry Outlook: Articles to read

Click on the title below to view the article

Current Perspectives: Breaking up is hard to do - Brexit Update
– *June 2016*

Have We Hit An Inflection Point? Epoch Investment Partners
– *May 2016*

The Case for Trade Remains Overwhelming, Epoch Investment partners
– *May 2016*

The Imbalance Game: Stumbling from one Crisis to the Next
– *April 2016*

Rethinking Fixed Income: How Private Debt Provides Investment-grade Quality, With Premium Yield, Benefits and Pension Monitor
– *April 2016*

What Would Negative Interest Rates Mean for U.S. Equity Markets? Epoch Investment Partners
– *April 2016*

Forward Perspectives: Debt – a Cause for Caution
– *March 2016*

Staff Updates

Additions	Date	Prior Experience
Jean-Francois Fortin Research Associate, Quantitative Equity	4/4/2016	Senior Analyst at a Financial Institution
Qi Sun, M.Sc. Research Associate, Quantitative Equity	4/12/2016	Research Assistant at a University
Keisha Bailey, MBA, CFA, FRM, Associate Portfolio Manager, Asset Allocation	6/13/2016	Market Risk Manager at an asset management firm
Mercedes Marchiori Associate, Fixed Income Trading	6/6/2016	Summer Student at TDAM
Amber Chen Analyst, Passive Fixed Income	6/1/2016	Co-op Student at TDAM
Ivan Chau Analyst, Portfolio Analytics	6/20/2016	Co-op Student at a financial services firm
Vivian Young, CFA Associate, Quantitative Equity Client Portfolio Management Team	6/20/2016	Associate in TDAM Investment Risk Team
Peter Park, CFA, Vice President Client Portfolio Manager, Asset Allocation & Equities	6/20/2016	VP Retail Investment Management at TDAM
Don Li, Associate Analyst, Investment Grade Credit Research	6/27/2016	Senior Analyst at a financial institution
Saurabh Puri Analyst, Portfolio Analytics	6/27/2016	Analyst at a software engineering company

Departures	Date
Olga Bylaard, CFA, Managing Director Managing Director, Active Fixed Income	4/1/2016
Vishal Bhatia, CFA, Vice President & Director Portfolio Manager, Passive Equity	4/12/2016
Ketan Desai, FRM, Vice President[1] Analyst, Asset Allocation	5/9/2016

[1] Role change to non-investment professional with a transfer to the TDAM Investment Manager Research Team

Fund Updates

Fund	Change	Details
TD *Emerald* Enhanced Canadian Equity Pooled Fund Trust	Fund name change	New fund name is TD *Emerald* Systematic Alpha Canadian Equity Pooled Fund Trust
TD *Emerald* Enhanced U.S. Equity Pooled Fund Trust	Fund name change	New fund name is TD *Emerald* Systematic Alpha U.S. Equity Pooled Fund Trust
TD *Emerald* Enhanced Hedged U.S. Equity Pooled Fund Trust	Fund name change	New fund name is TD *Emerald* Systematic Alpha Hedged U.S. Equity Pooled Fund Trust
TD *Emerald* Hedged Synthetic International Equity Pooled Fund Trust[1]	Fund name change	New fund name is TD *Emerald* Hedged International Equity Index Pooled Fund Trust
TD *Emerald* Hedged Synthetic U.S. Equity Pooled Fund Trust[1]	Fund name change	New fund name is TD *Emerald* Hedged U.S. Market Index Pooled Fund Trust
TD *Emerald* Low Volatility Global Equity Pooled Fund Trust	U.S. exposure investment guidelines	Please refer to fund profiles for updated information
TD *Emerald* Low Volatility All World Equity Pooled Fund Trust	U.S. exposure investment guidelines	Please refer to fund profiles for updated information

[1] When these Funds were originally launched here there was an opportunity to enhance returns relative to their respective Indices by investing in equity market futures and a money market portfolio. This allowed clients to gain exposure to foreign markets without being restricted by the foreign property investment limits that were in place for registered plans at the time. Since then, the foreign property investment limits have been removed and the opportunity for enhancement by investing in futures contacts and money market securities no longer exists. As a result, TDAM has changed the objective and guidelines for these funds and aligned the names as well. Please refer to updated profiles for the updated information.

We invite you to learn more about how our strategies and services can help you meet your clients' specific investment needs. Please visit us at www.tdaminstitutional.com or contact Brendan O'Brien at (416) 307-5878 (brendan.o'brien@tdam.com) for more information or feedback.

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