

# RISK PREMIUM STRATEGY

## *The Opportunity*

The long term total returns of the equity market result from cumulative earnings growth and the compounding effect provided by re-invested dividends. Over any finite time horizon, the realized returns for any given investor are strongly determined by the multiples at which the equities were purchased. When earnings-yields are low (growth expectations are high) subsequent returns have been quite poor. In contrast, when earnings-yields are modest to high (growth expectations are subdued) the subsequent returns have been good to very good. The question is then: how can an investor generate long-term returns commensurate with those of the equity market, but with less exposure to the vicissitudes of valuations? We believe that by systematically making use of equity index options investors can get appropriately compensated for taking equity risk in a manner that is less sensitive to valuations and therefore diversifying to their overall equity portfolio.

## *The GMO Solution*

Over the last 35 years, an investor who has systematically sold index put options has attained the same overall level of returns as long-only equity holders, but with a very different return profile. In particular, the returns generated by put sellers are less volatile and significantly less impacted by market valuations. The different return profile can be attributed to the source of the returns. In the case of traditional exposure to equities, the long-term returns are the result of price appreciation due to earnings growth and the initial price paid for that earnings' growth. Put sellers have, by definition, no exposure to the upside of the equity market: they get compensated for taking equity market risk via the so-called variance risk premium (VRP) which can be thought of as an insurance premium offered to investors who are willing to underwrite the risk of a correlated market drawdown. This insurance premium has, on average, been positive over time and is uncorrelated with market valuations. As a result, put selling strategies have historically delivered their returns in a manner that is remarkably insensitive to starting valuations. The GMO Risk Premium Strategy aims to capture the returns of the global equity market by systematically selling put options on major global equity indices.

## ACTIVE ALLOCATION

- Active allocation around the world allows us to exploit the most attractive option premium opportunities and gain exposure to markets that we believe are better positioned to outperform on a delta basis.



## EXTENSIVE GLOBAL TRACK RECORD AND EXPERIENCE

- GMO has been managing assets in the Risk Premium Strategy in a global fashion since its inception in 2012.

## ACTIVE DURATION DECISIONS

- Our ability to manage tenors and sell shorter- or longer-dated options allows us to better harvest systematic premia.

## IMPLEMENTATION AND RISK MANAGEMENT OVERVIEW

The GMO Risk Premium Strategy seeks to:

- Systematically sell near-the-money, short-dated put options on major global equity indices.
- Utilize proprietary models to dynamically set the strategy's exposure to different indices.
- Fully collateralize options when written, explicit leverage is not part of the strategy.
- Make use of exchange-traded and cash-settled options to mitigate risks of default or other counterparty exposure.
- Utilize only high quality short-term fixed income instruments to manage the cash and collateral.
- Continually monitor option market risk factors such as delta, gamma, and vega as well as currency exposure and collateralization levels.



### *The Client Fit*

The GMO Risk Premium Strategy can be used as an alternative approach to achieving global equity exposure and should be thought of as a component of an investor's overall equity program.

### *Who We Are*

Founded in 1977, GMO is a private partnership whose sole business is investment management. The firm manages global portfolios with offices and clients around the world. Investment offerings include equity, fixed income, multi-asset class, and alternative strategies. GMO is known for blended fundamental and quantitative investment research expertise and a long-term orientation toward value investing.

### RISK

Risks associated with investing in the Strategy may include Market Risk - Equities, Illiquidity Risk, Derivatives and Short Sales Risk, Management and Operational Risk, and Counterparty Risk.