



## Alternative Investing

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# Where the Wild Things Aren't: Using Derivatives and Leverage to Improve Portfolio Performance

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In the current world of modest risk premia, investors face a choice: Limit their investment options and concentrate their risks in traditional equities, or diversify and build more stable portfolios more likely to meet their difficult benefit and spending requirements. Choosing the latter course has a lot of appeal, but it will require — brace yourself — the prudent use of leverage and derivatives.

Investors who cannot or will not use leverage and derivatives are resigned to allow equity market direction drive their portfolio performance. We think a better option is to choose and manage your risks by applying modest leverage to a more diversified portfolio because we believe this approach delivers higher risk-adjusted returns with smaller tail events. Both concentration and modest leverage are risks, and nobody should tell you different. But concentrating in equities simply because it is the more common choice does not make it any less scary.

Leverage and derivatives are just tools. At their best they are useful — in some cases, essential — to reduce risks, by allowing investors to improve asset allocation, make shifts efficiently and cheaply, implement intended bets, close market inefficiencies that would be left open, and transfer risk between parties.

Particularly in a world of narrow risk premiums, growing liabilities and lofty return goals, improvement over tradition is necessary. The way forward is to use everything we have learned from experience and theory to invest wisely the great pools of assets we manage.

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