

What tools can help equity investors amid Middle East uncertainty?

Investment strategy insights

Author: Matthew Carter, Strategist, UBS AG London Branch

- As investors become more encouraged that a durable end to the US-Israel-Iran war is in sight, they may want to look for tools that can help them stay committed to stocks or generate income from them, while using features to potentially reduce losses if markets wobble again.
- We discuss certain types of financial instruments called structured strategies that use derivatives. Structured strategies may offer investors flexibility, with a potential ability to tailor their equity exposure according to their market outlook and risk appetite.
- It is important that investors understand the unique features and characteristics of derivatives before investing, especially how structured strategies fit as part of a well-diversified portfolio and a wider financial plan. For some investors, there may be alternative tools to structured strategies that better match objectives and risk tolerance.



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Investors have become more encouraged that a durable end to the US-Israel-Iran war is in sight. News of ceasefires between the US and Iran, and between Israel and Lebanon have led some financial markets to rise to pre-war levels.

The US S&P 500 index reached fresh peaks, with the US benchmark surpassing the 7,000 level for the first time recently. And gauges of expected prices swings, also known as volatility, have fallen from high levels, with equity implied volatility (a measure of how much stocks may go up or down according to financial markets) returning to historical averages for most major stock markets.

Investors may want to look for tools that can help them stay committed to stocks or generate income from them, while using features to potentially reduce losses if markets wobble again.

These types of tools, called structured strategies, may help equity investors navigate this challenging period. Different tools can support investors under varied circumstances, depending on which market scenario transpires, investors' equity positioning versus financial plans, and their appetite for risk.

Structured strategies use certain types of financial instruments called derivatives. It is important that investors understand the unique features and characteristics of derivatives before investing, especially how structured strategies fit as part of a well-diversified portfolio and a wider financial plan. For some investors, there may be alternative tools to structured strategies that better match objectives and risk tolerance.

Structured strategies may, nevertheless, offer investors flexibility, with a potential ability to tailor their equity exposure according to their market outlook and risk

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appetite.

For example, investors who doubt whether the present rebound can last but are also keen on maintaining equity exposure can consider tools that look to limit potential losses from here via a put warrant. This type of hedge involves buying a put option (the right but not obligation to sell a security at a pre-defined price) on a stock an investor already owns. This strategy may offer downside protection during a correction in the underlying asset.

Using put warrants on stocks demands awareness and careful management of the risks. Using this tool on a stock or market an investor already owns means terms can be tailored to market demand, the maximum loss is known in advance, and investors are typically not be subject to margin calls.

Investors looking to put cash to work in stocks because they have too few relative to their plans may be fearful of a market downdraft. A tool called a capital preservation note may provide an alternative to buying stocks outright. This type of investment may help to limit potential losses in the event of renewed volatility.

These structured instruments combine a non-income-paying (zero-coupon) bond—which returns the initial capital investment at maturity—with call options (a type of financial market derivative) that provide exposure to a potential recovery in the underlying asset.

Capital preservation notes can be customized for the investment length, the amount of losses an investor wants to avoid, and the degree of potential gains an investor would like to participate in if the underlying asset rallies. This may allow investors to tailor the degree of capital protection and market gain participation.

Risks to this type of tool that investors must be willing and able to bear include issuer default (the risks that the issuer of the tool cannot repay investors), liquidity constraints (a more limited ability to sell the tool in periods of market stress), and the need to hold the note to maturity for capital preservation features to apply (with capital preservation only guaranteed at expiration.)

Other investors may want to diversify their sources of portfolio income. Rather than positioning for further potential gains, investors may want to consider a tool called a reverse convertible as a means to generate yield in parts of the equity market where implied volatility remains above average.

A reverse convertible combines a bond paying regular coupons with a put option, allowing the issuer to sell the underlying asset to the investor at a predetermined strike price. If the asset's price is above the strike at maturity, the investor receives their initial investment in cash plus the

coupon. If below, the investor receives the asset or its cash value, typically at a loss.

Investors may consider this tool if they are looking for higher yields, a way to generate fresh sources of steady cash flow, or the opportunity to acquire stocks at a preferred lower price.

Setting the strike price at the level where the investor wants to buy allows them to “wait out” uncertainty and potentially acquire the asset at a discount.

Risks to this type of tool include loss of capital if the asset falls significantly, issuer default, limited liquidity, and price transparency issues. However, the coupon payments can partly compensate for taking on these risks, and CIO has developed selection techniques that would allow investors to incorporate reverse convertibles into a well-diversified portfolio.

Investors should not expect smooth sailing from here. It's true that CIO expects equities to deliver further gains by year-end. But we believe investors must face the fact that the path may be bumpier than currently priced by markets.

Global asset class preferences definitions

The asset class preferences provide high-level guidance to make investment decisions. The preferences reflect the collective judgement of the members of the House View meeting, primarily based on assessments of expected total returns on liquid and commonly known indices, House View scenarios, and analyst convictions over the next 12 months. Note that the tactical asset allocation (TAA) positioning of our different investment strategies may differ from these views due to factors including portfolio construction, concentration, and borrowing constraints.

Attractive: We consider this asset class to be attractive. Consider opportunities in this asset class.

Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.

Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities

Note: For equities, we have a five-tier rating system with two additional preferences

Most Attractive: We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.

Least Attractive: We consider this asset class to be among the least attractive. Seek more favorable alternatives opportunities.

When equities are included with the other asset classes in the three-tier rating system, we collapse "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive."

Appendix

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