SCG's Merrill On How Derivatives Mitigate Risk And Goose Equity Returns

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Ian Merrill, president of SCG Asset Management, which runs The Alternative Strategies Income Fund, a continuously offered closed-end interval fund. Read the Q&A below as Ian says that investors can change the risk-reward picture in equities by using derivatives to reduce risk but also set up the potential for higher income. He suggests that using derivatives allow a classic 60-40 balanced investor to go to 50-30-20, with derivatives representing the last part of the allocation and generating returns that normally would require a lot more equity exposure. Merrill says that the explosion in derivative products, driven in part by the success of defined outcome ETFs, makes it incumbent on investors to avoid confusion and make sure they know the investment intentions for any manager using derivatives.


Ian Merrill

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Ian Merrill, president of SCG Asset Management is here and we're talking about the impact that derivatives can have on a stock portfolio, welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today, well, we're looking at a different way to own closed-end funds and to get exposure to derivatives with Ian Merrill, he's president of SCG Asset Management, which runs The Alternative Strategies Income Fund. That's ticker symbol LTAFX, it's a continuously-offered, non-diversified closed-end interval fund. Yeah, that sounds like a lot, but you should know most of those terms, and it helps investors access derivative strategies with low investment minimums and without having to be an accredited investor. Want to learn more about the firm and the fund? Go to SCGAMLLC.com. And if you want to check out some of the jargon and make sure you understand it, you want to size up interval funds, and closed-end funds and business-development companies generally, check out AICAlliance.org, the website for the Active Investment Company Alliance. Ian Merrill, welcome to The NAVigator.

IAN MERRILL: Morning, Chuck. Thanks so much for having me.

CHUCK JAFFE: So we need to start with derivatives because derivatives can be a lot of things. People sort of assume that they're super complicated, but options and futures are forms of derivatives, basically it's a contract. So we need to understand what kind of derivatives you're talking about and what they can help you do, not only in an equity portfolio, but in an interval fund structure where you're not facing redemptions on a moment's notice, which can become a difficulty when you're using derivative strategies.

IAN MERRILL: Great question and great to talk about this. I think it's important for investors to understand that there's just been a massive proliferation of derivative-based products in the marketplace, and I think it can create quite a bit of confusion as to what the intention of the product is and how it works. So to your question on what type of derivatives, in this case it's all derivative contracts linked to equities, so listed stocks, and in our case it can be a number of different stocks with a minimum market cap that we look to select the highest income paying derivative contract linked to that stock. So what do I mean by that? A number of folks equate a use of derivatives, "Oh, I remember the CDOs and other structured products that had a lot of negative press over the years."

CHUCK JAFFE: Yep.

IAN MERRILL: Think about a structured note as simply a zero-coupon bond as the delivery mechanism for an options contract. And in our case, the bond is issued by a big bank, so it's a well-rated SEC instrument that its performance is linked to the performance of a particular stock and there are observation periods of how the stock has performed, and if it reaches a certain performance level the holder can get an income payment, meaning a coupon, for that particular investment. And what we've done is taken what is still a very small segment of the marketplace, so think about structured notes and structured equity derivative products being maybe 2% of the investment marketplace. Last year there were about 130 billion notional structured notes issued in the US markets, so still very, very small compared to the ETF and mutual fund space, but if you understand how they work, they can be very beneficial to a sliver of a portfolio. And in this case, we think that if you're targeting income for your portfolio, so let's say your typical portfolio is 60-40, equities, fixed-income, a sliver of that equity portfolio, some doing 5-8% of that portfolio is seeking high-income streams with regularity. And as your listeners know, the design of an interval fund is to have that periodic but planned for income on a quarterly basis, and that's exactly what we've built with our fund. And what we've done is take away the headache of going out and sourcing multiple structured notes yourselves, which a number of registered investment advisors do, but we handle everything. It's in one portfolio, 30 to 50 notes, we handle corporate actions, if there's a merger or something else that occurs, we handle all that, and so you're literally just tracking the income that comes into the portfolio. We feel like the time is right for more focus on derivatives because we've seen, to my earlier point on proliferation, these so-called defined outcome ETFs that are all over the market now, where people are starting to see what was a very traditional structured note payout where you have some downside protection and potentially some upside participation, now really go more mainstream. So we're building on that but also doing something quite targeted on the income side, but what we're doing can be done for growth portfolios as well. But it all fits under this broader category of alternatives, and we know that's one of the hottest terms in the marketplace now, but people have to understand what we mean by that.

CHUCK JAFFE: It also brings in one of the hottest discussions, for a long time there has been a lot discussed about whether or not the 60-40 portfolio was dead. But it wasn't about whether or not derivatives would be used, it was about is that enough fixed income allocation back at the times when interest rates were so low, et cetera. As I understand it, and I'm hoping you're going to make sure that we all understand it, one of the things that using these derivatives strategies allows you to do is to say, "Yeah, I don't want to be 60-40 in terms of how I construct a portfolio. I want to be more of like 50-30-20. But oh by the way, because that 20 is the derivative side of things, it gives me 60-40 or better results with less risk." Right? That's the real thing that's key here is I can make this portfolio deliver what I want and do it more safely at a time when people are talking about do classic structures work? This is a non-classic structure with classic returns, right?

IAN MERRILL: A hundred percent, and I think you've hit it on the head in the 50-30-20. So really the 20 can be cut up in a number of different sleeves, and I mentioned income earlier but it doesn't have to be income, but you're exactly right. What you don't want to have is just a portfolio with equities heavily correlated with one another that all go down at the same time, or almost at the same time, and when you're heading into what will undoubtedly be a very volatile year as we head towards Super Tuesday, the election, obviously all the things that are going on in the world, what a number of investors experienced in the last financial crisis but also during Covid, is that sleeve of derivative instruments really protected the portfolio from these large sell-offs. As you recall those days during Covid, we had the 1,000-point swings in the Dow multiple days, over multiple weeks. And so what you want is that 20% really diversifying away from the traditional mix of bond ETFs, equity ETFs, but really having a sliver that is protective but also could pay materially higher income than in other investments. So what we see people doing is your private equity sleeve is within that 20, you have the derivative instruments within that 20, and we've talked to a number of folks who have model portfolios that they built based on that 50-30-20, that really started as a number of the sophisticated pensions said, "We think this is a better mix of a diversified portfolio." We've all heard and talked a lot about the concentration that people have in technology stocks, particularly post-Covid, the so-called phantom stocks where you also have all the chip names, so you also don't want to have just hold ETFs that hold all of the same securities. A number of ETFs all hold Tesla, that's potentially a good investment, but again from a diversification and portfolio performance point of view, you really want to focus on that 20. And I think any very sound advisor advising, whether it's families or individuals, should really be thinking more about the make-up of that sleeve and educating the clients on the costs of that. Because of course there is a cost to protecting a portion of your portfolio, but in the long run most likely better to stay invested in that 50-30, but having some mitigating products in the 20.

CHUCK JAFFE: It's really interesting, there's a lot more nuance to it. I hope we get a chance to talk again down the line, flesh some of that out and talk more about how derivatives can impact and balance a portfolio. Ian Merrill, thanks so much for joining me on The NAVigator.

IAN MERRILL: My pleasure. Thank you so much, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe, and you can check out my hour-long weekday podcast by going to MoneyLifeShow.com or by searching wherever you find your favorite podcasts. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. Thanks to my guest Ian Merrill, president of SCG Asset Management, which runs The Alternative Strategies Income Fund, ticker LTAFX, a continuously-offered closed-end interval fund. Get information on the firm and the fund at SCGAMLLC.com. The NAVigator podcast is new every Friday, we hope you'll sign up to make sure you don't miss an episode. Tell your friends about us and come back next week, and until then, happy investing everybody.

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