Trade war is no reason to abandon risk, but a good reminder to take out insurance

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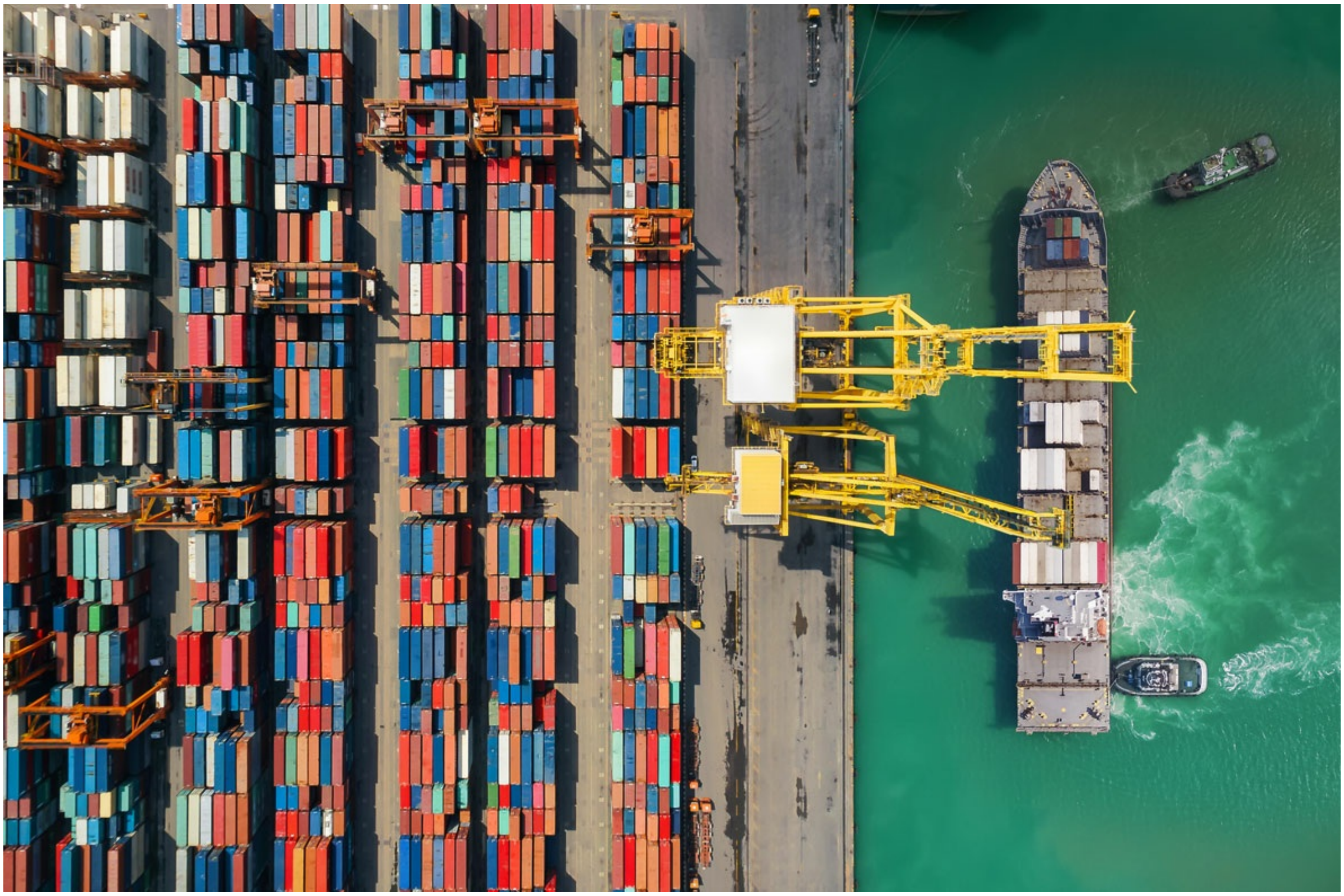

The recent correction, driven primarily by China trade war concerns and the subsequent potential impact to global growth, has given investors cause to consider their options: either take 2019 profits where they can and reposition to a more "risk-off" posture; maintain an aggressive "risk-on" allocation; or seek a happy medium.

Trade war fears notwithstanding, the market has been in an unhealthy environment for some time. Artificially-low interest rates, held down by central banks desperate to promote growth, have provided a fundamental safety net under equities, which have continued to rise as interest rates continue to mark lower lows. If both rates and equities were trending upwards, it would be a signal of a transition to a more normal, higher-growth environment where investors truly believe in the economy's potential even without further bank stimulus.

For the time being, central banks remain accommodative, rates remain low, and equities, pending a trade war resolution, appear poised to continue a slow, steady climb. So how should one position their portfolio? One approach would be to add "insurance" by increasing developed market interest rate exposure alongside equity market exposure. In the current environment, this provides both income and some protection, while keeping the opportunity to participate in the upside of further gains from equities.

Another option is to protect an equity portfolio via put options. Though more costly, they can offer substantial protection, especially amid a rapid correction in equities and increasing market volatility.

Downside protection within a portfolio makes sense in many environments, but even more so today. Doing so in a way that still allows the opportunity to participate in the upside of a return to higher growth rates that don't need central bank augmentation is even better. A complete "risk-off" allocation belies the significant risk of equity outperformance, given that the economy and markets remain reasonably healthy overall.

While increasing caution in portfolios is warranted, a simple "risk-off" approach goes too far in an equities market that may still have significant life in it. Positioning for short-term protection against recent gains via adding equity options may make sense for some. And a larger strategy of using bonds to hedge against equity positions is an attractive hedge as the market navigates negative macro catalysts in its bid to capitalize on strong fundamental economic measures.

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