Risk Management in ETFs: The Shape of Returns

Why how a strategy manages risk matters as much as what it owns

KEY TAKEAWAYS

- Risk management in a fund is not just about avoiding losses. It is about aiming to shape the trade-off between upside participation and downside protection.
- A fund's net exposure (long[1] minus short[2], as a % of assets) determines how much of the market's move the fund participates in. Long-only funds run about 100% net; hedge funds[3] typically run less.
- For investors evaluating funds, risk-adjusted return[4], return per unit of risk, can potentially be a more meaningful measure than headline return alone.

Overview

Every investment strategy involves a trade-off between return potential and risk. Different fund structures shape that trade-off differently. Two funds with identical headline returns can carry meaningfully different levels of underlying risk, and the structure that produced the return is part of what investors are choosing when they allocate.

A fund's structure determines the shape of the return it can deliver. A long-only equity fund is built to participate fully in market direction. A hedged equity fund is built to participate selectively, with the upside-downside trade-off explicitly designed in.

Why It Matters

Comparing funds on absolute return[5] alone can be misleading. As a hypothetical illustration, a fund that returned 8% with a maximum drawdown of 25% delivered a different experience than a fund that returned 8% with a maximum drawdown of 10%, even though the headline number is identical. For investors, the path matters, not just the destination.

This potentially matters when:

- The investor is approaching or in retirement, where drawdown timing affects outcomes
- The portfolio is concentrated in growth-oriented assets and could potentially benefit from a counterweight
- The objective is wealth preservation alongside growth

In each case, the fund's structural approach to risk, not the manager's recent track record, is what determines whether it fits.

How It Works

In our view, the most important structural variable in fund risk management is net exposure.

Long-Only

~100% NET EXPOSURE

Holds only long positions. Returns generally track market direction closely. Potential participation in rallies, and exposure to drawdowns.

Hedged

~50% TO 70% NET EXPOSURE

Combines long positions with an actively managed short book. May potentially capture less in rising markets; short book can potentially offset losses in declines.

A long-only equity fund holds only long positions, so its net exposure is roughly 100%. When the market rises, the fund generally tends to rise. When the market falls, the fund generally tends to fall. A hedged equity fund combines long positions with short positions (securities the manager believes will fall, or held as hedges against market risk). Net exposure is the difference between the two, typically 50% to 70% for most hedged equity strategies.

A market-neutral fund aims to balance long and short positions so that net exposure is approximately zero, with returns driven by relative performance rather than market direction. There is no universally right net exposure. Risk-adjusted measures, Sharpe ratio[6], maximum drawdown[7] and downside capture[8], may be used alongside absolute return.

Practical Implications

For advisors and investors evaluating fund strategies, three potential takeaways follow.

1. **Evaluate funds on risk-adjusted return, not just absolute return.**[5]
   Look at the Sharpe ratio, maximum drawdown, and how the fund performed in declining markets versus rising markets. Two funds with the same total return are not necessarily delivering the same outcome.

2. **Match the fund's structural design to the investor's objective.**
   A long-only fund suits investors seeking full market participation. A hedged fund suits investors who want equity exposure with dampened volatility and are willing to give up some upside in exchange.

3. **In drawdown periods, structural risk management proves its value.**
   A hedged structure is most distinguishable from a long-only one not when markets are rising, but when they are falling. That is when the design, not the manager's market-timing, does its work.

At Clough Capital

The Clough Hedged Equity ETF (CBLS) is built around this structural approach to risk. CBLS typically operates with net exposure of 30-70%, combining a high-conviction long book with an actively managed short book. The structure is designed to participate in market gains while cushioning downside in periods of market stress. It is not a market-timing strategy; the hedging is built into the construction of the portfolio.

Definitions

1. A long position is ownership of a security, held in the expectation that its price will rise. A fund holding a long position gains if the security's price increases and loses if it falls.

2. A short position is a position that gains if a security's price falls. The manager sells a borrowed security and must later buy it back to return it, so the position loses if the price rises instead. Because a price can rise without limit, losses on a short position are not limited to the amount invested.

3. A hedge fund is a pooled investment vehicle, generally offered privately to institutional and qualified investors, that may use strategies such as short selling, leverage and derivatives. Hedge funds are not registered investment companies and are subject to different regulatory requirements from ETFs and mutual funds. An ETF that hedges is not a hedge fund.

4. Risk-adjusted return is return considered in relation to the amount of risk taken to achieve it, rather than on its own. Sharpe ratio, maximum drawdown and downside capture are among the measures used. All of them describe periods that have already happened and none of them predicts future results.

5. Absolute return is the total return of an investment over a stated period, stated on its own rather than relative to a benchmark or to the risk taken to achieve it. It does not describe how the return was produced.

6. Sharpe ratio is a measure of risk-adjusted return. It is calculated as a portfolio's return in excess of the risk-free rate, divided by the standard deviation of those excess returns. A higher Sharpe ratio indicates more return per unit of volatility. It is one of several measures investors may consider and does not predict future results.

7. Maximum drawdown is the largest peak-to-trough decline in a portfolio's value over a stated period, measured before a new peak is reached and expressed as a percentage of the peak value. It describes the worst decline an investor who held throughout that period would have experienced.

8. Downside capture is a measure of how much of a benchmark's negative performance a portfolio experienced over a stated period. A downside capture ratio below 100% indicates the portfolio declined less than its benchmark during the periods when the benchmark fell.

IMPORTANT DISCLOSURES

Investors should consider the investment objectives, risks, charges, and expenses carefully before investing. This and other information are contained in the prospectus, which may be obtained by visiting www.cloughcapital.com/etfs or by calling 855-393-0559. Please read the prospectus carefully before you invest.

Risk Factors: Investing involves risk including possible loss of principal. The equity securities held in the portfolio may experience sudden or prolonged declines due to market-wide or issuer-specific factors. Short selling involves significant risks, including potentially unlimited losses if a security's price rises, ongoing expenses, and counterparty risk. The ETF's use of options for hedging or income may not be effective, may not fully protect against losses, and may result in additional costs or exposure to loss.

Active management involves higher fees and the risk of underperformance relative to passive alternatives. There is no guarantee that an active strategy will outperform its benchmark or that any investment objective will be achieved. The success of an actively managed strategy depends on the portfolio manager's skill, research process, and judgment, all of which involve risk.

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There is no guarantee that a fund will achieve its investment objective. An investment may lose value, including the possible loss of principal.

A hedged strategy is not guaranteed to prevent or limit losses. The fund may decline in value, and investors may lose money, including their principal investment.

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