

Defending Against Tail Risk

Tail risk is the name given to the existence of rare disasters — the observation that adversity strikes with greater frequency and severity than suggested by models based on the symmetrical bell curve, or normal probability distribution. Some of the most famous asset pricing anomalies are attributable to tail risk. For example, the relatively large risk premium of equities over bonds is ascribed to uncertainty surrounding the true frequency of market crashes. In options pricing, the relatively high implied volatility of far out-of-the-money options (the “volatility smile”) is similarly explained by uncertainty surrounding the true frequency of outsized price movements. In currency markets, the apparent free lunch of a carry trade consisting of borrowing in a low interest rate country and lending in a high interest rate one (the interest-rate parity puzzle or “peso problem”) is justified by the tail risk of a sharp devaluation of the high-yielding currency.

The 2007-09 financial crisis and the continued economic and market dislocation that followed in its wake posed a new puzzle for investors: how to structure portfolios that can meet long-run return objectives in a world in which 100-year floods arrive with disconcerting frequency. With memories of the market turmoil spawned by the credit crisis fresh in investors’ minds, and the prospect of continued turbulence on the horizon, there has been a proliferation of strategies promising tail risk protection. We are concerned that investors may be disappointed with the cost and effectiveness of tail risk protection and, in a search for a quick fix, may discard time-honored methods of portfolio design and risk management.

Tail risk hedges are understandably enticing, as they suggest that it is possible to have your cake and eat it too. Sadly, however, tail risk hedging is not a free lunch. Attempting to truncate the downside comes with a potentially high cost, as evidenced, for example, by the volatility smile. This cost can be in the form of periodic premium payments, or the opportunity cost of foregone returns.

Whatever the form, hedging costs are especially high in the immediate aftermath of a crisis, when markets anticipate further turbulence. Not surprisingly, these are times when investor interest in tail risk is at its peak. Purchasing hedges when their price is high is contrary to value-based investing. The ill-timed proliferation of expensive strategies promising tail risk protection often distracts investors from basing their investment decisions on an assessment of the long-run relative valuation of assets.

Beyond the issue of cost, it is important to identify what type of risk is being hedged. Strategies designed to protect against a U.S. stock market crash, for example, may not provide adequate protection from a spike in inflation, an intensification of the euro area crisis, or a hard landing in China. There is no single hedge for all forms of tail risk.

Equally troublesome are the operational issues raised. Inherent in tail risk hedging is an element of market timing. How much of the portfolio to hedge and the type of risk posing the greatest concern will vary over time. As a result, hedges need to be actively monitored and managed, with frequent decision points. All too often, investors will maintain an expensive hedge over a long period at considerable cumulative cost, only to abandon the protection in the calm before a storm. We are currently closely evaluating selected tail-risk hedging strategies for reducing credit exposures. While the costs of tail-risk hedging strategies can be quite high, especially over time, the active strategies under consideration are expected to add value that would mitigate some of the costs. These strategies would have the benefit of allowing us to retain current allocations to niche credit investments with promising alpha potential, while reducing their exposure to a broad-based spike in credit spreads from current fair levels.

Given the inherent costs, potential ineffectiveness, and operational difficulties of tail risk hedges, we advocate a more fundamental approach to solving the puzzle of managing portfolios in a world where multiple 100-year floods should be expected in an investor’s lifetime. This approach includes the construction of a broadly diversified portfolio across and within asset classes, taking a long-run perspective based on fundamental asset valuations. Indeed, a focus on fundamental valuations can reveal opportunistic investments created by the market dislocation of a tail event. Rigorous analytical techniques should be applied to identify the risk factor exposures underlying each asset class and embodied in the portfolio as a whole. Such analysis is essential for effective diversification and for the implementation of tactical tilts designed to exploit divergences from fair value. Hedge fund strategies can be employed to minimize market risk and benefit from a wide range of uncorrelated streams of added value. Risk analytics, including the modeling of tail risk scenarios, help test a portfolio’s robustness as well as its alignment with the investor’s objectives and risk tolerance.

There are no shortcuts to keeping investment portfolios afloat in a 100-year flood. Basing investment decisions on fundamental valuations and rigorous risk analysis remains critical. Being prepared for the possibility of tail risk is a key element of good governance, which reduces the likelihood of counterproductive knee-jerk reactions, including the purchase of overpriced tail risk hedges at times of market distress.

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