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Understanding tail-risk hedges and funds - part two

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In our previous installment of this series, we laid out a basic introduction to tail-risk that outlined what it is, its most common variations, and discussed the debate around whether these events can be adequately hedged. In this installment, we will take a deeper view with two risk experts who say that investors should be employing tail-risk hedge strategies.

The Paradox
"Tail-risk funds are going to be popular until the markets improve again," says Damian Handzy, CEO of Investor Analytics, a US-based risk management firm.

Tail-risk is often simplified as an insurance policy against adverse market events, akin to a homeowner's policy. On the surface this looks like an easy sell, however, the same people that can readily imagine various levels of home destruction often have a difficult time imagining portfolio destruction. This is especially true at the top of a market - the precise point when investors should have a tail-risk plan in place. "Tail-risk protection is needed the most at the top of the market, but people start panic buying at the correction, when it's too late and too expensive," he says.

Part of the problem is that tail-risk strategies in of themselves aren't especially cheap at any point. It is less expensive overall to take an out-of-the-money position at the top of a given market, but it's not free. According to Richard (Jerry) Haworth, Co-Founder and CIO, of UK-based investment firm, 36 South Capital Advisors, investors need to examine the cost relative to the return.

"A tail event is a rare event so you should get paid multiples. If it's likely to occur once every ten years and it'll pay 10 times, then the pay off equals the probability and that makes sense. But, if it looks to happen every 10 years and only pays 3 times, that's very expensive, then it becomes tail insurance not a tail fund opportunity. It comes down to what the investor is willing to pay for both of those."

What color is your swan
In order to understand the probability of these events and their potential effect, investors and managers alike have to understand what tail events are and if they can be adequately predicted. "People have a hard time defining tail-risk, (we say a move greater than three standard deviations), but they don't know what volatility to apply to get to that number, or how to implement an effective hedge. I've seen some ridiculous strategies. Hedging for a ten percent move is not a tail event." Haworth explains.

"There are two types of tail events grey swans and black swans. Black swans are unknowable. Grey swans are knowable. What we see going back to 1987 is that about every five years you see a tail event '87, '94, '97, '98, '2000, '01, '08. So we try to be realistic in making those predictions. To Paulson, 2008 was not a black swan event. It was a grey swan event."
He defines a grey swan as having medium probability with medium impact. Whereas, black swans have a low probability and high impact when they occur. According to Haworth, a key realization that people need to make about portfolio management overall is that volatility and correlation are not constant. Once investors and mangers shift their perspective, they can begin to understand risk and tail-risk hedges more appropriately.

These distinctions are what separate tail-risk hedges from plays on volatility. "Some people interpret tail-risk as extreme volatility but they are fundamentally different. Volatility players use a combination of options and aren't always focused on extreme events," Handzy says. "Tail-risk hedges are focused solely on extreme price movements."

Understanding the nuances around tail-risk is important to constructing a strategy that will be an effective hedge without simply transferring risk or moving money to the sidelines.

Cash is not always king
"You need a bespoke tail-risk solution that looks at targeted securities. The idea of a generic tail-risk fund is tricky to me. Tail-risk hedges are typically buying deep out of the money puts, buying a lot of put options is a really expensive proposition, if you're just doing it without a plan as a big hedge," Handzy says.

According to Haworth, if a tail-risk strategy is going to be effective, it should be at least a 5 year plan, that buys convexivity when it's cheap and has the full backing of the investment committee. Poorly constructed tail-risk hedges without a long-term plan can simply transfer the risk. "Writing calls to buy puts is a bad tail-risk hedge, all you are doing is swapping the risk of one tail for another, if say, there was a significant increase in inflation," Haworth says. Both men agree that investors cannot simply diversify their way out of tail-risk. Handzy notes that during the 2008 crisis all correlations went to 1, making diversification irrelevant.

Some investors and managers argue that a significant cash position is another way to approach tail-risk. However, both men note that while going to cash does effectively remove the risk, it can create its own set of complications. Cash makes investors heavily dependent on timing in terms of when to get back into the market, it can also expand the length of time it takes for them to recover losses. While having an effective tail-risk hedge in place would have paid out when the rest of the portfolio was going down.

"Just going to cash is not really a viable hedge against a tail event. You're just taking all the risk off the table, and you're saying deflation is on the horizon. If it goes to inflation there's not a light at the end of the tunnel there, you're looking at an oncoming train," Haworth says.

The next part of the series examines the structure of tail-risk funds and is available here.

Full article link (subscription required): http://www.opalesque.com/642858/Understanding_hedges_and_funds_part285.html