JOURNAL ARTICLE

Tail Risk Hedging: Contrasting Put and Trend Strategies

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The sharp market fall and speedy recovery during the eventful first half of 2020 has kept tail risk hedging topical: investors have both fresh memories of a painful loss and renewed fears of a repeat. In this paper we summarize many of AQR's key findings over the years on risk-mitigating strategies and try to offer a balanced overview of the strengths and weaknesses of direct and indirect tail hedging strategies.

For brevity, we represent direct tail hedges with long out-of-the-money (OTM) index put strategies ("Put"), and indirect tail hedges with multi-asset-class trend-following strategies ("Trend"). We address two big questions: (1) What is the long-term average return or cost, and (2) How reliable and efficient is the hedge in equity market tail events? We present empirical answers and discuss the economic rationale on each question. The common view that Put costs more but is a more effective tail hedge contains a kernel of truth but does not capture the full story. We will give a more nuanced picture, including practicality for investors, and end up preferring Trend over Put.

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"Tail Risk Hedging: Contrasting Put and Trend Strategies" was one of six papers recognized as "Highly Commended" in the "Best Quant Paper" category of the Savvy Investor Awards 2020, recognizing its depth, quality, readability, appeal and relevance to an institutional investor audience. Read more from the Savvy Investor.