Asset Allocation

Tail-Hedging Strategies

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Tail hedges are one way to potentially limit losses in adverse markets. They may better enable investors to stick with their positions through bad times and thus be long-term. Tail hedges may even create potential for investors to opportunistically pick up risky assets in times of market distress (often at fire-sale prices).

Traditionally, tail-hedging strategies rely on the equity index options markets, which offer downside protection, but at a substantial cost. Not only do these strategies carry a negative long-term expected return, they also tend to be more expensive when most needed.

Economically, this makes sense, as investors should expect to pay for the right to transfer risk to another party, and to pay more when that risk is greater. However, the high cost makes it less likely that investors will have patience to keep bleeding the "insurance costs" through sometimes many years of normal market conditions.

An alternative approach should be more cost-effective and provide protection against the dominant risk in a portfolio — typically, equities. Trend-following strategies are one example: They cannot give as reliable downside protection as index puts, but they have provided surprisingly consistent safe-haven services when most needed, while delivering positive long-run returns.

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