PORTFOLIO RISK AND PERFORMANCE

Working Your Tail Off: Active Strategies vs. Direct Hedging

June 1, 2015

Economic theory and empirical evidence support the idea that investors should, over the long term, be compensated for bearing risk. Thus, any discussion of tail risk should rationally start from the premise that it's something that contributes to a portfolio's expected returns.

In this paper we demonstrate that several active strategies that are straightforward to implement in portfolios not only deliver superior long-term average returns but also outperform direct hedges in prolonged market drawdowns. Importantly for investors, these indirect hedging strategies can be combined, and a portfolio of them may offer investors a more robust way to mitigate their sensitivity to the worst drawdowns in equity markets. In contrast, we find direct hedging is costly and only delivers value when combined with the ability to time short-term market crashes and the ability to unwind those hedges very shortly after those events. We question investors' ability to do either of those.

Capital market risk includes tail risk. While preparing for and embracing risk is one element of investing, a second element is to capture risk in the most efficient way possible. More efficient portfolios make it "easier" to bear risk if they can be constructed to be better behaved, with more-consistent risk levels and, ideally, fewer and smaller tails. Compared with direct approaches to hedging portfolio tail risk, the indirect approaches described in this study have offered a more efficient way of working your tail off. Directly buying portfolio insurance through options, while risk-reducing, does not lead to more-efficient risk taking.

eliminate the risk of experiencing investment losses.

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