Journal Article

Tail Risk Hedging: Contrasting Put and Trend Strategies

February 28, 2021

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.

Published in the Journal of Systematic Investing.

"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.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. The views and opinions expressed herein are those of the author and do not necessarily reflect the views of AQR Capital Management, LLC, its affiliates or its employees.

This information is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein. Past performance is not a guarantee of future results.

AQR Capital Management, LLC, ("AQR") provide links to third-party websites only as a convenience, and the inclusion of such links does not imply any endorsement, approval, investigation, verification or monitoring by us of any content or information contained within or accessible from the linked sites. If you choose to visit the linked sites, you do so at your own risk, and you will be subject to such sites' terms of use and privacy policies, over which AQR.com has no control. In no event will AQR be responsible for any information or content within the linked sites or your use of the linked sites.