INVESTMENT BRIEF

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Strategic Investment Group®

Hedging the Tail Risk of Wider Credit Spreads

As we discussed in our Outlook and Strategy, we face a potentially turbulent period ahead as markets adjust to the likelihood of the Federal Reserve stepping back from the extraordinary monetary policy known as quantitative easing. In this context, we are considering the adoption of tail-risk hedging strategies to allow us to retain niche credit strategies expected to add value, while securing some protection against a spike in credit spreads.

Tail risk is the name given to the existence of rare disasters — the observation that adversity strikes with greater frequency and severity than suggested by models based on the normal probability distribution. A tail risk hedge is expected to provide a positive return in a severe market dislocation, such as a sudden widening of credit spreads.

In the current ultra-low yield environment, the value of fixed income investments and their role in institutional portfolios is coming under increasing scrutiny. The possibility that the post-crisis legacy of extraordinarily low yields may be coming to a close makes it especially important to assess the underlying exposure of bonds to different risk factors.

Fixed income securities span a wide continuum of sensitivities to market factors. Maturities range from one month to over 30 years, while credit quality ranges from AAA-rated sovereigns to companies on the verge of default. We use a fixed income factor model to understand the widely divergent sensitivities of different securities and strategies to different sources of risk, while seeking to optimally structure bond portfolios, with a view to maximizing expected risk-adjusted returns.

Although the risks of bonds can be reduced by simply underweighting them, bonds serve an essential function of providing liquidity and portfolio diversification, even in an environment of rising interest rates. We have over the past several months adopted a number of tactical portfolio shifts in response to the ultra-low interest rate environment — including a meaningful underweight to portfolio duration — while taking steps to diversify the fixed income portfolio away from highly overvalued safe haven bonds. Moreover, we have continued to favor active fixed income strategies that are likely to continue to add value even at potentially turbulent turning points in interest rates. We would like to retain the benefit of such active strategies while reducing the exposure to tail risk from the impending turning point. Credit tail-risk hedging strategies may offer a means to do this.

Unfortunately, although tail risk hedges are naturally tempting to investors seeking safety, there is no free lunch in hedging. Attempting to truncate the downside comes with a potentially high cost, and the expense tends to be highest just when a hedging strategy is most on the minds of investors — just after a crisis. These costs accumulate over time as the tail risk hedge is maintained.

Nor is tail risk hedging risk-free. The two primary risks associated with implementing tail-risk hedging strategies are basis risk and governance risk. Basis risk results when the instrument used to hedge does not perform as expected. Correlations are notoriously unstable, and tail risks can disrupt the ability of markets to clear. As a result, the negative correlation expected from the hedge may not materialize in a crisis, or it may not be possible to realize the benefit of the hedge as a result of disruptions to market liquidity. Governance risk may arise if the direct and indirect costs of the hedge are not fully appreciated from the outset. Hedges will have negative returns in good times, and are not expected to pay off unless other parts of the portfolio are suffering.

Tail-risk hedging strategies may be useful in a limited set of circumstances. First, the cost of the tail risk hedge must be fair, well understood, and deemed to be acceptable. Second, the tail-risk hedge instrument must consistently be highly negatively correlated to the risk being offset, especially during times of market disruption. Third, tail risk hedging requires skilled managers to maximize the effectiveness and minimize the cost of the hedge.

We are currently closely evaluating selected tail-risk hedging strategies for reducing credit exposures. While the costs of tail-risk hedging strategies can be quite high, especially over time, the active strategies under consideration are expected to add value that would mitigate some of the costs. These strategies would have the benefit of allowing us to retain current allocations to niche credit investments with promising alpha potential, while reducing their exposure to a broad-based spike in credit spreads from current fair levels.

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