Tail Risk and Hedging

Introduction

Tail risk is technically defined as a higher-than-expected risk of an investment moving more than three standard deviations away from the mean. For mere mortals, it has come to signify any big downward move in a portfolio's value. The term was revived in the year 2008 during global recession. It indicates the extreme or "black swan" events which are beyond the control and result in hefty losses.

The same risk is revving up again as revolutions in the Middle East and Japan's earthquake have destabilized markets and increased volatility, leaving battered investors searching anew for protection.

Hedging

1. To create a basket of derivatives that will perform poorly during normal market conditions but soar when markets plunge. These include options on a variety of asset classes, such as equity indices and credit-default-swap indices.

2. Buy tail-risk products. For example Deutsche Bank has created the ELVIS index, which generates returns when stock market volatility increases. Big asset managers like BlackRock and PIMCO have made a business of advising customers on managing for the worst case. Several "tail funds", which invest in assets that should rise in bad economic times, have started up in the past few years.

3. The price of hedging varies, rising when markets are volatile and investors most need it, and declining during bull markets.

4. It costs investors between 0.5% and 1% of assets to hedge against tail risk, but that investors will break even in three to five years.

5. Peddlers of tail-risk products like to compare them to insurance: investors pay premiums every year to avoid financial catastrophe later.

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