Viewpoint

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Is Hedging the New Diversification?

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November 2011

As sophisticated investors take a fresh look at portfolio risks in the wake of the global financial crisis, many of them have given up on *diversification* and are now more focused on *hedging*.

Executive Summary

ISSG Senior Investment Strategist Bob Jaeger warns that the current interest in hedging against downside risk often underestimates the explicit and implicit costs while overestimating the protection provided. The global financial crisis of 2008/2009 bred disillusionment with traditional approaches to diversification, but Bob argues that investors did not have the appropriate kind of diversification across risk-on and risk-off assets. Genuine diversification, he says, still provides an opportunity to improve risk/return ratios, while hedging is best viewed as a tool for reducing risk.

As sophisticated investors take a fresh look at portfolio risks in the wake of the global financial crisis, many of them have given up on *diversification* and are now more focused on *hedging*. They complain that "diversification failed" during the global market meltdown of late 2008/early 2009, because "all correlations went to one." They have therefore adopted a hedging strategy, either buying "tail risk insurance" or perhaps pursuing what ISSG calls "the Goldilocks approach" to portfolio construction. The Goldilocks approach divides the total portfolio into three main "bowls": (1) equities and other growth assets (private equity, equity hedge funds, high yield bonds, etc.) for the Just Right environment, when growth and inflation are well-behaved; (2) inflation hedges (mainly TIPS, commodities, and commodity-related equities) for the Too Hot environment, when rising inflation shuts off growth; and (3) deflation hedges (mainly U.S. Treasuries and other sovereign debt) for the Too Cold environment, when growth turns negative and inflation may even turn to deflation.

The Goldilocks approach can be an effective asset allocation tool, but only when guided by a realistic sense of what hedging is all about. Diversification can fail, but so can hedging. Diversification can be a free lunch, in the sense that it can improve return while reducing risk. But hedging is primarily a risk-reduction tool. The "free lunch" issue is especially important in the current environment, where so many investors are

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looking for portfolio protection that the standard inflation and deflation hedges all look potentially expensive, and "regular old equities" may be the value hidden in plain sight. When home-owners buy fire insurance, houses do not thereby become cheaper or more flammable. But when investors flock to portfolio protection assets, those assets become expensive and the assets they're trying to protect may become attractively cheap.

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Diversification vs Hedging

To appreciate the contrast between diversification and hedging, six points are essential:

1) Diversification didn't fail during the global market meltdown, and not all correlations went to one. Rather, investors weren't adequately diversified: they owned a long menu of risk-on assets (oriented toward generating return) but not enough risk-off assets (oriented toward safety and liquidity). Correlations among the risk-on assets went to one, but the correlation between risk-on assets and risk-off assets went to minus one.

2) Diversification is based on *low* correlation, while hedging is based on *negative* correlation, or, better yet, negative downside correlation. That is, the protecting asset will make money when the vulnerable asset is losing money, without losing an equal amount when the vulnerable asset is making money. Thus, the ideal hedging asset is either an option or an option-like asset that can deliver asymmetrical returns.

3) Options have an explicit cost, and option-like assets are likely to have an implicit cost, in that they may lower the expected return of the total portfolio. The standard inflation and deflation hedges (commodities, inflation-linked government debt, and nominal government debt) aren't literally options, but they are expected to deliver option-like asymmetrical returns. That is, they are expected to boost performance in environments that are hostile to equities, without killing performance in equity-friendly environments. But if hedging assets behave like options, it's prudent to assume that they will have an implicit cost, thus lowering the return of the total portfolio. ISSG historical analysis suggests that the cost of insurance may be less than one might expect, but we know that history is often an imperfect guide.

4) The mantra that "diversification is the only free lunch in investing" is true in one sense but not another. Diversification presents an *opportunity* to build more efficient portfolios, that is, portfolios that offer higher return for a given level of risk. However, "free lunch" can also mean "opportunity for risk-free arbitrage," which diversification definitely isn't. Diversification involves the blending of risks; it's not scooping up $100 bills lying on the sidewalk.

A more thoughtful approach to portfolio construction will include both robust diversification (as opposed to ersatz diversification across a menu of risk-on assets) and value-conscious hedging when the cost/benefit analysis adds up.

5) Hedging is not a free lunch in any sense of the term. Hedging is best viewed as a tool for reducing risk, not for improving the return/risk tradeoff. Moreover, hedging does not deliver arbitrage-like profits. This is obviously true for the standard option hedges (e.g., buying puts for insurance), and it's equally true for the various return spread hedges that are common among hedge funds: buy cheap stocks, short expensive stocks; buy good companies, short bad companies; buy high yield debt, short low yield debt (and similar carry trades). All these hedges may generate attractive returns, but none of them is guaranteed to do so. In fact, many hedge fund trades have the same generic profile: buy the more risky asset, short the less risky asset, thus capturing a risk premium. When investors go into risk-off mode, these hedges are bound to fail.

6) Diversification is often viewed as a long-term strategy vulnerable to short-term shocks, whereas hedging is often viewed as a more opportunistic strategy designed for short-term protection. But it's important not to overstate this distinction: hedging can make sense as a long-term strategy (many commodity-based companies hedge the commodity price as a matter of policy), and some hedges are vulnerable to short-term shocks.

Many investors are attracted to hedging because they believe it offers more protection than diversification, but they also don't want to give up return. That's a tall order in the best of circumstances, and virtually an impossible order given the current market circumstances. Hedging strategies are potentially expensive and not necessarily bullet-proof. A more thoughtful approach to portfolio construction will include both robust diversification (as opposed to ersatz diversification across a menu of risk-on assets) and value-conscious hedging when the cost/benefit analysis adds up.

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