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Global Experience, Local Knowledge

Hedging for Different Market Scenarios

A look at specific strategies, and their trade-offs, for diversifying equity risk.

More investors are considering broadening their approach to diversifying equity risk to include strategies such as long duration bonds, managed futures, alternative risk premia, and tail risk hedging. However, it's important for investors to know in what types of environments each strategy is more likely to work and in what environments each are likely to be less effective.

What this chart shows

Not every type of risk-mitigating strategy can be expected to work in every type of market sell-off.

- **High quality sovereign bonds**, such as long duration U.S. Treasuries, have historically been an effective hedge during flight-to-quality episodes, but can incur negative returns if interest rates rise faster than consensus expectations.
- **Trend-following strategies** have historically performed well in trending markets and could pair well with long duration bonds (for example, the trend-follower can reduce interest rate risk by shorting rates during a sustained sell-off in rates), but are susceptible to rapid reversals in trends.
- **Alternative risk premia strategies may enhance a trend-following/long duration bonds combination further, as they have the potential to do well in non-trending markets and can act as an uncorrelated return driver. But they can be vulnerable to parallel drawdowns in multiple risk premia, however uncommon these might be.**
- **Tail risk hedging may offer a higher degree of reliability, albeit at the expense of short-term return potential. In contrast to the approaches above, tail risk hedging is based on contractual derivatives – not correlations, which can break. And contrary to conventional wisdom, tail risk hedges do not always have a negative expected return or a cost associated with them.**

HEDGING EFFECTIVENESS VARIES BY MARKET SCENARIO

Source: PIMCO. **Sample for illustrative purposes only.**

What it means for investors

There is no "silver bullet" strategy to hedge an investor's portfolio from risk events. We believe that investors should "diversify their diversifiers" by identifying the ideal blend of correlation-based hedges and outright hedges for their unique circumstances.

Source: PIMCO
https://www.pimco.com.au/en-au/resources/education/hedging-for-different-market-scenarios

US Banking Collapse – Why?

Visited New York recently and came across this sign on a branch of The First Republic Bank. The bank collapsed recently and was acquired by JP Morgan Chase. Why did they collapse? The Wall Street Journal on 1 May 2023, said It failed to reckon with the impact of rising interest rates, which sent its strategy of relying on wealthy depositors into reverse".

Stress testing for rising interest rates is a basic and routine practice in banks, which was reinforced by all Banking Regulators after the 2008 global crisis. Yet First Republic Bank ignored this or didn't act on the results of this stress test. Their business had grown significantly in recent years and perhaps this risk, was not considered important.

As Warren Buffet famously said "Only when the tide goes out do you learn who has been swimming naked."

Ignoring basic risks and going for aggressive growth is a risk, that many individuals and business owners are tempted to make, when building their wealth. Hence it may be wise finding the right professional help you... and avoid the risk of a collapsed investment.

Over my career I sometimes meet with people are panicking, usually when faced with a personal crisis where they may have business debt. Sometimes this may include having to provide for dependents. As you can imagine this creates enormous added pressure.

Three years ago, I met with a small business owner who was referred to me, by P&A Accountants and Advisors, who was experiencing significant financial pressure and needed some assistance.

Having recently been divorced with children, she needed help with getting her business debts under control, and having her cash flows and insurances reorganized.

It took some thought and effort to re-structure and streamline these areas.

Today, the business debt is paying itself off, on schedule. Her life cover secures her financial situation from accident, illness, or death. Her cash flows are strong and under no pressure with the rising interest rates.

She has bought a new home and is building her retirement wealth steadily.Her discipline in staying with agreed financial strategies, has paid off well.

Sound financial advice could help in resolving financial challenges in a methodical way.

If you have clients in the midst of a panic, just like the P&A Accountants client, I am here to help.

P&A ACCOUNTANTS

WE'RE HERE TO HELP

As you keep your long-term goals top of mind, remember: we are here to help – with news, insights and helpful resources available on our website,
www.bluerocke.com
to help keep you up-to-date on the latest.

End of financial year is just a few days away. Make sure you are prepared with this Australian Government checklist: https://business.gov.au/finance/yearly-financial-tasks/end-of-financial-year-checklist