A TWO-MINUTE GUIDE

EQUITY BASED

Managed Volatility
Targets the purchase of low-volatility equities. These strategies offer similar returns to the equity market with less drawdown risk.

Asset Allocation/Dynamic Timing

Market-Regime-Aware Investing
Using a proprietary regime-timing model the market regime is identified and the asset allocation mix adjusted to match—allocating less risky assets in higher-risk market regimes and more risky assets in safer times.

Target Volatility Triggers
Rules-based strategy that dynamically adjusts the exposure of assets within a portfolio to target a consistent level of portfolio risk. When volatility is high, exposure to equity is reduced.

Upside Participation
Yes

Uses Derivatives
No

Strength
Equity-like return potential over time with less volatility

Drawback
Risk of mistiming the market regime

Optimized Beta
These risk parity-like approaches seek to allocate risk, rather than capital, across a portfolio. So, for example, instead of a traditional 60/40 stock/bond mix, you might target a specific risk level.

Volatility Exposure Management
Selective exposure to volatility can constitute an effective hedge. These strategies opportunistically invest in VIX futures when the timing makes sense.

Overlay Management Through Derivatives

Zero-Premium Put-Spread Collar
Downside protection is provided by buying puts (limiting downside). Then the cost of this protection is offset by the cash generated from selling a call on the same trade.

PROFITING FROM TAIL-RISK HEDGING?

Yes, a dynamic volatility trading strategy using VIX futures is one tail-risk solution that potentially can. The graph below shows why a long-volatility investment is a natural tail-risk hedge. When the MSCI All-Country World Index declines sharply, as it did in 2002 and 2008, volatility, as measured by the CBOE VIX index, often tends to rise dramatically. Volatility is also mean-reverting, which adds to the appeal of owning it as a risk-reducing strategy.

Global Equity Index Returns and VIX Levels (Jan 1990–Nov 2013)

WHAT IS TAIL RISK?
The “tail” in tail risk refers to the end sections of the bell-shaped curve. The shaded area represents the lowest returns, whereas the right-hand side represents the highest returns.

The art of tail-risk protection is to asymmetrically seek to protect against left-hand events (those which are loss making) while maintaining participation in those events on the right (which are profit making). There are a number of ways that investors can help limit tail risk—including using derivatives or simply choosing sectors that are less volatile.

TAIL RISK OR DOWNSIDE PROTECTION?
You can think of the first and second standard deviations on the left-hand side of the tail as downside protection. By the point you are three standard deviations beyond the mean, you are firmly in tail-risk event territory.

Beware of Fat Tails and Banks of Black Swans

Tail events are exceedingly infrequent in a normal curve but market tail curves are much “fatter” than normal curves meaning that tail events are much more frequent than many investors realize.

This above is for illustrative purposes only. Standard Deviation is a historical measure of the volatility of returns. If a portfolio has a high standard deviation, its returns have been volatile, so a standard deviation estimate of future returns may reflect a shorter time frame. This may not depict a true historical measure, and should not be relied upon as an accurate assessment of volatility.

Higher probability of big losses

Standard Deviations

Normal distribution

‘Fat tail’ distribution

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Risk associated with equity investing include stock values which may fluctuate in response to activities and general market and economic conditions. Derivative investments may involve risks such as potential illiquidity of the markets and additional risk of loss of principal. Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Diversification does not ensure a profit or guarantee against loss.

Investing in futures is highly risky. Futures positions are considered highly leveraged because the initial margins are significantly smaller than the cash value of the contracts. The smaller the value of the margin in comparison to the cash value of the futures contract, the higher the leverage.

There are a number of risks associated with futures investing including but not limited to counterparty credit risk, currency risk, derivatives risk, foreign issuer exposure risk, sector concentration risk, leveraging and liquidity risks.

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