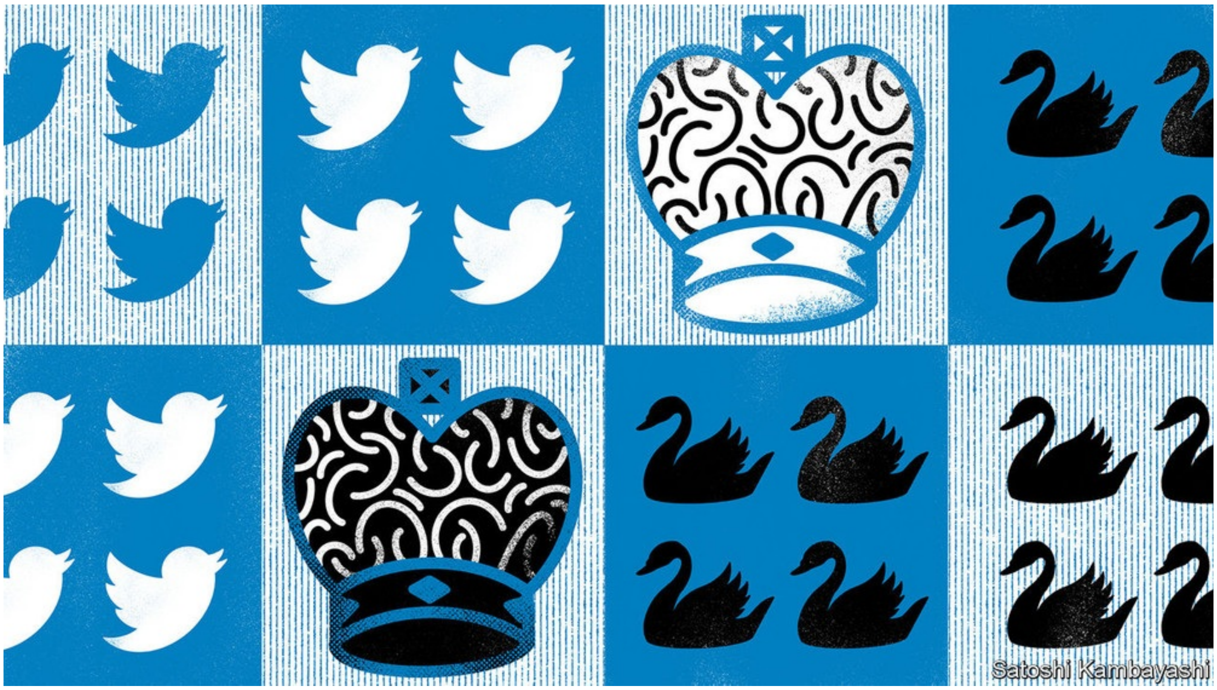
Buttonwood

Is there a role for options insurance in equity portfolios?



IN 1993 Nigel Short, a British chess player, became an unlikely TV star. This was a consequence of the staging in London of a chess match between Mr Short and Garry Kasparov, the world's best player. Channel 4 carried highlights. Sustaining interest was a challenge, though. Two men hunched over a board is not a great spectacle. A bigger problem was the baffling complexity of top-level chess. Even a club-level player could not easily work out who was winning.

This brings us to a more recent battle of the brainboxes. Nassim Nicholas Taleb and Cliff Asness, two high-level thinkers on finance, had a forthright exchange of views on social media about the efficacy of buying options to hedge a portfolio of risky shares. Mr Taleb, author of "The Black Swan" and adviser to Universa Investments, an options specialist, says it is the only robust way. Mr Asness, founder of AQR Capital Management, says there are better methods.

Mr Asness's case is backed by empirical work by AQR eggheads, the gist of which is that people overpay for insurance in the long haul. Not yet proven, is the judgment on Mr Taleb's view. Everybody loves a highbrow Twitter row. The grandmasters will debate the subtleties. But even the club-level investor can take something away. It is a spur to thinking about how to build sturdier portfolios.

Start, as even grandmasters must, with an opening: you buy a broad index of shares. You are now exposed to the volatility of equity prices. Stocks may fall sharply in downturns. You might usefully balance your portfolio with government bonds. When recession hits, these tend to rise in price as interest rates fall. Bonds are thus a form of insurance. And normally, at least, they pay the insurance-holder a small return: the yield.

A recent paper* from AQR looked at the worst periods for a "60/40 portfolio" (60% equities; 40% bonds) since 1971 to see if options-based insurance did any better. Unsurprisingly, options-protection pays off handsomely in crashes, like the one in February-March this year. Indeed an options-protected portfolio did better than 60/40 in bad periods lasting up to three years. But equity prices tend to recover from crashes eventually. And over time the insurance premiums demanded by options sellers add up to a drag on performance. By the ten-year horizon, 60/40 trumps the options-based portfolio. Other risk-mitigation strategies did even better than 60/40 over time.

On AQR's reckoning, then, passively buying equity options has been a relatively dear way of mitigating risk over long periods. This is valuable knowledge. It also makes intuitive sense. When you buy home insurance, you know the odds are stacked in the insurer's favour. The firms are in it to make a profit. Yet that does not make buying insurance foolish: it allows you to take on the risk of a big mortgage.

So might financial-options insurance sometimes make sense, too? In some cases, only a direct form of insurance will do. Take a hypothetical producer of beef. He might expect an annual return of 10% on his business over ten years. But those returns are volatile. Their sequence matters. If beef prices were to slump for two straight years, say, it would mean bankruptcy. The cost of insuring his output using options might lower his average yearly return to, say, 6%. But he might judge that worthwhile to be sure he would stay in business. A similar logic applies to a retiree living off a lump sum. A big drop in share prices would cut deeply into her income. She might not be able to wait for other risk-mitigation methods to come good. Nor is there a guarantee that they would work as well as in the past. Bond yields are close to all-time lows, for instance, implying less scope for them to pay off if the stockmarket takes another lurch downwards.

The price of equity options varies greatly over time. It can make sense to use them when they are relatively cheap, says Vineer Bhansali of LongTail Alpha, a firm that specialises in risk mitigation. In principle, more judicious options buying—finding those with the best potential payoff for the price, including options on other financial assets—could lower the cost of insurance. It is a big ask for the club-level investor, though it may be possible for grandmasters.

Complex situations can befuddle even the best minds. After a few dozen moves in one of the Kasparov-Short games, the grandmaster pundits agreed that Mr Short had lost. As he rose from the board, they thought he had conceded. But no: the game was a draw.

*“Portfolio Protection? It’s a Long (Term) Story”.

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