

# Risk

*matters*

Edition 8



## Dangers of **drawdown**

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# Interview; Tail risk: Dark clouds on the horizon

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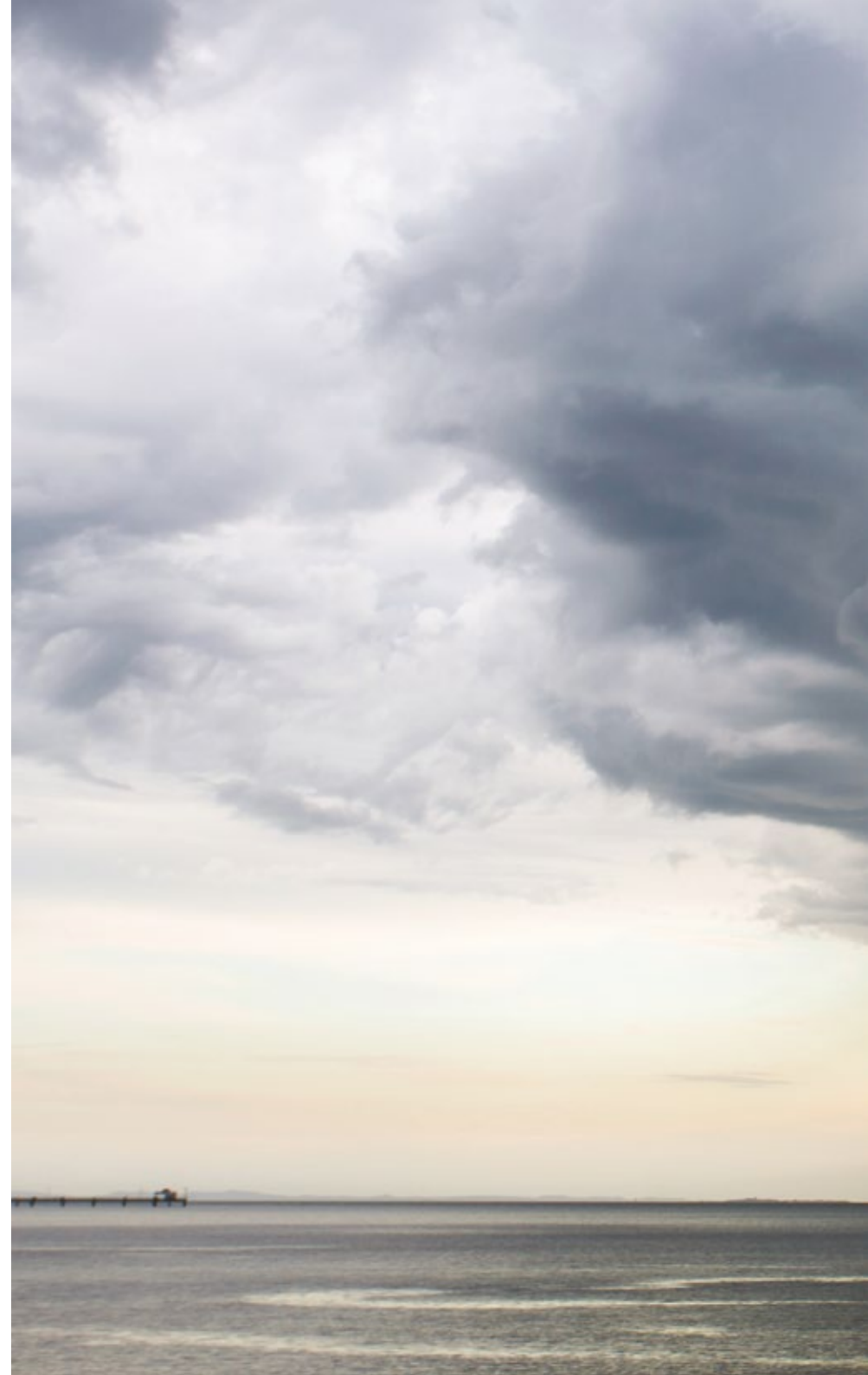
Dr. Reinhold Hafner is CIO of AllianzGI Global Solutions and Head of risklab.

What are “tail risks”, and why should you care?

Even if you know what they are, do you know what they mean for your investments? Risk expert Reinhold Hafner explains. ▶

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**“ ...investors need to take more risk in order to achieve adequate returns... The biggest risk for investors today is probably not to take any risk at all. ”**

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**Q There has been talk about “black swans” and tail risks for a number of years. What do these terms mean?**

In the financial services industry, a black swan describes a very unlikely and severe event capable of sending shock waves through financial markets as a whole, or specific asset classes. Due to its nature, such an event cannot be predicted. The bankruptcy of Lehman Brothers in September 2008 was an example. Within six weeks of the shock, the German stock market had fallen by 30 percent. With losses of that size, you will find yourself on the far left tail of the distribution of returns. That is where the term comes from.

**Q How can you evaluate the impact of these events on a portfolio?**

A black swan is, by definition, unforeseeable. True, there are scenario techniques that might be helpful in this context, but these remain incomprehensive. In the end, what matters to an investor, is the loss itself as opposed to the cause of the loss. That’s why the definition of tail risk does not necessarily include an unexpected or unknowable event, but is rather linked to the existence of extraordinary or severe losses.

**Q How can investors protect themselves against tail risks?**

Tail risks can have a completely different impact depending on the individual situation: those who were fully invested in equities in 2008 will recall the collapse of Lehman Brothers as a nightmare. In contrast, for investors in Bunds, the year was one of the best ever. To cut a long story short, tail risks have to be viewed and

analysed individually from the respective portfolio. That means that there is no “one size fits all” solution for tail risk hedging.

**Q What choices do investors have then?**

There are two options: firstly, to sit things out. In most cases, investors could recoup their losses after a few years. Therefore that could – in principle – be an option for investors with a long investment horizon and without mark-to-market reporting requirements. But: there are not so many investors that can hold their position ignoring mark-to-market losses. In addition, the Japan example shows that it might take decades to recoup the losses: even 25 years after the bubble burst, the Nikkei stock index has not yet recovered. For most investors, that’s probably not the right approach.

**That leaves portfolio protection...**

Well, yes, all types of investor would see this as the preferred route. However, portfolio protection or better risk management is a question of the right design. Because our clients want both – attractive returns and protection against tail risks.

In principle, you can protect a portfolio in two ways. One is by using an options-based strategy where you buy put options, as these are effectively able to cap losses in the respective asset classes.

The second route, which has attracted much more demand from our client base, is risk management implemented through dynamic asset allocation. We shift between asset classes using futures, and create an asymmetric risk profile – with participation



in upside markets and protection against severe losses – similar to the options strategy. The beauty of this approach is that it is much more cost-efficient and flexible than the options strategy. The latter, though, has an advantage; it offers immediate protection in the case of events like 9/11.

**Q Does the low interest rate environment and shrinking market liquidity impact dynamic risk management?**

Liquidity risk is a big topic. We always maintain vigilance on the liquidity of instruments used in our downside protection



strategies, and this has become even more important. As banks have substantially reduced their proprietary trading, and hence take less risk on their books, even in deep markets such as government bonds, liquidity occasionally becomes scarce. With that happening, the likelihood of tail risk increases. You could argue that regulators achieved the opposite to some degree in their honest desire to make markets less volatile and less vulnerable to tail risks via regulation. With the low yield environment, investors lose their yield buffer. Once government bonds yielded five percent, or had a comparable coupon, that helped as a buffer in times of falling prices. Nowadays, with 10-

year Bunds yielding one percent, drops in price almost immediately translate into losses.

### **Q** What does all of this mean for private investors?

We see that investors need to take more risk in order to achieve adequate returns. That means they have to increase their exposure to risky assets such as equities and emerging market securities, as well as alternative assets. The biggest risk for investors today is probably, not to take any risk at all.

Unfortunately, diversification alone is not enough to limit tail risk effects. The diversification effect breaks down when you need it most. There is a saying that “in a crisis everything goes down except correlations”. That’s why I would strongly advise looking for additional protection through dynamic risk management. But most private investors won’t be able to set this up by themselves. Multi-asset funds with embedded dynamic risk management are therefore a good choice. ●

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<sup>1</sup> Source: Defaqto, as at February 2015.

<sup>2</sup> Source: Rayner Spencer Mills, as at January 2015.

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