

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

Risk



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

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

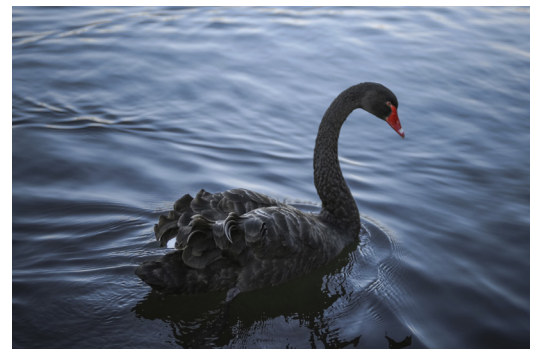
In the financial services industry, a black swan describes a very unlikely and severe event capable of sending shock waves through financial markets as a whole or specific asset classes. Due to its nature, such an event cannot be predicted. The bankruptcy of Lehman Brothers in September 2008 was an example. 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.

**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.

**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.

**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 option 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.

### **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, 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 to look for additional protection through dynamic risk management. But most private investors won’t be able to set this up by themselves. Multi asset investment vehicles with embedded dynamic risk management are therefore a good choice.

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