The Dilemma of Hedging

Assuming you're not the type of investor whose mood is synchronized with the daily gyrations of the stock market, October has been an interesting month. Although it's not over yet so of course anything can happen, to this point October looks like a big, short-lived margin call. Leveraged investors and those who like to hedge their downside have had a torrid time and many must regard their recent activity wondering how so much frenetic portfolio adjusting could have been so harmful.

It will be especially interesting to see how hedge funds finish the month. Industry apologists long ago perfected shifting the goalposts of performance. What was once the Absolute Return industry moved to generating attractive relative returns, later supplanted by uncorrelated returns as each description of the performance objective was found to be at odds with the empirical results. Nowadays sophisticated hedge fund consultants promote downside protection as the raison d'etre of a hedge fund allocation.

So what to make of the way October is shaping up? Through yesterday, the S&P500 was down 1.6% for the month, an innocuous result that scarcely describes the wealth adjustment that was inflicted earlier. MLPs, in which we have more than a passing interest, were at one point down 14% before the V-shaped market move thankfully began its ascent.

Hedge funds, as defined by the HFRX Global Hedge Fund Index, are currently estimated to be down 2.5%. Many hedge funds, particularly those focused on equities, have done far worse. Stocks may of course spend the rest of the month falling, but assuming they don't one imagines there will be some uncomfortable conversations as investors contemplate the value destruction that's possible when hedged strategies test the market timing skills of their practitioners beyond the level

of their ability.

It’s a fair question to ask that, in a market environment characterized by a sharp trip down followed by an equally fast return, what exactly should a hedged strategy return? Presumably, if a hedge fund maintains constant exposure, the round trip ought not to be much different than for the long only investor. But it’s looking very much as if the risk management being practiced is of the “dynamic” variety, which is to say highly responsive to market moves, or perhaps less generously, prone to sell low and buy high.

It reminded me a little of the crash of October 1987, whose 27th anniversary of course just passed on Monday. Not nearly as traumatic of course, and spread over a longer period of days, but what both events have in common is the use of hedging strategies that rely on risk reduction in response to falling prices. In 1987 it was called Portfolio Insurance. Its 2014 version has more complexity and variety of implementation, but thematically is another version of taking more risk when prices are rising and less when they’re not. There are other ways to grow your savings.