JOURNAL ARTICLE

Portfolio Protection? It's a Long (Term) Story…

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AQR Q2 2020 Alternative Thinking

Recent headlines focus on option-buying strategies and their extraordinary performance in March, usually leaving out their generally high long-term cost. The tail insurance strategies with the largest wins in crash months are likely ones that in good times lose all or most capital allocated to them, perhaps many times over.

Investors have a natural urge to protect their portfolios from sudden crashes like the one we've seen recently. We argue that they should instead focus on bad outcomes that unfold over longer periods, as those tend to be more detrimental to the long-term goal of wealth accumulation.

We show that options-based hedging can be effective over shorter periods but tends to weaken over time. In contrast, risk-mitigating and diversifying strategies such as defensive equities, risk parity, alternative risk premia, and trend-following have more consistently added value over the horizons that matter most — as well as on average. This latter point suggests a crucial advantage for these strategies: that unlike options-based hedging, it's never "too late" to consider diversifying into them.

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