Understanding Equity Hedges

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With stocks on a rollercoaster ride this year, Russ discusses the various potential hedges that could smooth the ride.

2019 is fast becoming a year of extremes. After the best start to the year in decades, U.S. equities experienced one of their worst Mays on record. While stocks have subsequently bounced, the damage to risky assets lingers.

The Nasdaq Composite and Russell 2000 indexes flirted with correction territory, down 10%, while semiconductor stocks approached bear market territory, down 20%.

Given the sudden shifts in the market, investors are once again exploring how to best hedge equity risk.

The challenge is that not all hedges work in all circumstances. For example, what helps insulate a portfolio against higher inflation is not the same as what you'd want to own if you were worried about a recession.

The good news today, to the extent there is any, is that investors know what they're trying to hedge: a trade-induced slowdown. And if a slowing economy is the proximate danger, history suggests three, fairly reliable portfolio hedges: duration, gold and the yen.

Lessons from history

My colleague Paul de Vassal examined S&P 500 drawdowns of 10% or more going back to the late 1990s. What he found was that the traditional "risk-off" hedges generally worked, albeit to varying degrees.

The most obvious and traditional hedge — U.S. Treasuries — gained an average of about 2% when equity markets corrected. Investors can do better by buying longer-duration Treasuries, but obviously at the cost of more risk (see Chart 1). Outside of duration, two other classic hedges also performed in a similar manner. Both gold and the yen also gained about 2% when equity markets were faltering.

S&P 500 drawdowns and hedge performance

start	end	SP500	UST 3-5Y	UST 5-7Y	UST 7-10Y	UST 20+Y
7/31/1998	8/31/1998	-16.1%	2.2%	2.9%	3.6%	5.0%
3/27/2000	4/14/2000	-11.1%	1.5%	1.8%	2.2%	2.7%
9/12/2000	10/12/2000	-10.6%	1.3%	1.5%	1.3%	-0.1%
2/16/2001	3/16/2001	-13.2%	2.3%	2.7%	3.1%	3.9%
8/27/2001	9/21/2001	-18.4%	2.6%	2.7%	2.4%	-0.9%
6/25/2002	7/23/2002	-19.5%	2.5%	2.8%	3.1%	2.9%
9/12/2002	10/9/2002	-14.5%	2.2%	2.8%	3.4%	3.8%
1/15/2003	2/13/2003	-12.1%	1.3%	1.5%	1.9%	3.2%
12/27/2007	1/22/2008	-12.4%	4.4%	5.2%	6.1%	7.2%
6/17/2008	7/15/2008	-10.5%	2.7%	3.0%	3.4%	4.7%
9/29/2008	10/27/2008	-29.9%	2.1%	1.0%	0.4%	2.5%
2/10/2009	3/9/2009	-22.0%	0.4%	0.7%	1.4%	1.8%
4/26/2010	5/26/2010	-12.1%	2.1%	3.4%	4.6%	9.3%
7/8/2011	8/8/2011	-17.2%	2.3%	4.3%	6.2%	12.6%
7/31/2015	8/25/2015	-11.3%	0.6%	0.9%	1.2%	1.9%
12/30/2015	1/20/2016	-10.4%	1.6%	2.3%	2.8%	5.6%
1/29/2018	2/8/2018	-10.1%	-0.2%	-0.7%	-1.3%	-3.8%
12/4/2018	12/25/2018	-15.6%	1.2%	1.5%	2.0%	5.1%
	Average	-14.8%	1.8%	2.2%	2.7%	3.7%

Source: Bloomberg, as of June 5, 2019

The third hedge, the yen, is the least obvious. Why would owning Japan's currency help insulate a portfolio? Part of the rationale lies in the yen's role in carry strategies, i.e. borrowing in a cheap currency to fund better yielding assets. Historically, these strategies tend to unwind when volatility rises, which means investors need to buy back yen. As a result, as with Treasuries, the yen has had a consistently negative correlation with stocks since the early 2000's.

Bottom Line

The bottom line for investors is that in an environment in which softening growth is the big threat, there are hedges that have worked relatively well during the past 20 years. For investors looking to maintain equity exposure but also manage risk, a combination of these three should help insulate a portfolio if things turn more interesting.

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