Notes on a Successful Tail-Hedge Strategy

(Editor's Note: This is a submission from our sister network,* IIN*, a private, password-protected online community exclusively for asset owners. This page features an interview with Zurich-based Sanostro, a provider of hedging strategies. Sanostro and Institutional Investor have a financial relationship going back a few years. But Sanostro does not have access to IIN or FON.)

If downside protection was your aim and you were fully hedged against the S&P 500 by 2016's second day of trading, then, firstly, congratulations. Secondly, might we ask how, precisely, were you able to pull off such a deft tactical move?

We put this question to a relatively new industry player, **Sanostro**, which finds itself taking something of a victory lap these days.

- ***A provider of signals to investors seeking to put on timely hedges, Sanostro not only timed the equity convulsion correctly, it also caught the drop in oil prices. In fact, they hedged all oil exposure for most of 2014 and 2015. In both of those years, Sanostro saved clients about 30%.***

Instinctively, we find ourselves seeking to poke holes in the Sanostro strategy of aligning with systematic trend followers purely to have access to their dynamic market indicators such that they might be shared with Sanostro's clients. (Who, it is worth adding, only pay Sanostro if their downside-hedge works.)

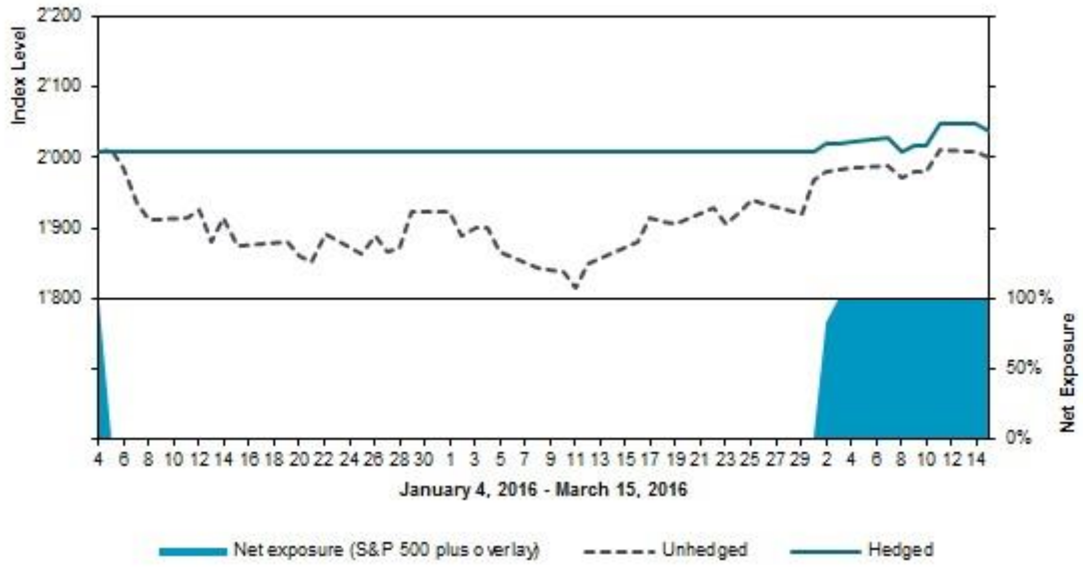
Sanostro has been waiting for this moment to truly be put to the test. And they are feeling confident having advised, essentially, a "risk off" call starting in early January and lasting until early March (see chart below). Firm founders insist that what they do works better timing-wise than gut feelings or fundamentals.

The following is an edited transcript of a series of interviews done in mid-March with Sanostro founders **Wolfgang Batt** and **Vincent Couson**.

IIN: *So the S&P 500* is [*as of 3/17/16] pretty much flat on the year, which is pretty remarkable considering at one point in February it was down 10% on the year. I suppose this is as good a time as any to be a provider of downside-hedge timing signals…*

Vincent Couson: "At the moment it looks like the dust has settled a bit, but we all know that the mood can change quickly again."

Wolfgang Batt: "The point with risk management is not to second guess the markets but to be prepared and have a systematic and disciplined approach. You have to set it up in advance, so that once you enter stormy waters again you only have to execute your predefined strategy. Avoid making decisions under stress."



IIN: *Tell us, specifically, how you steered clients clear of recent left tail events*.

Couson: Clients became more risk aware again after the sharp and fast correction in August 2015 and inquiries for downside protection picked up. In the case of the equity markets our signals triggered two meaningful hedging periods since then. The fist hedging period started during the week of August 17th, right before the exceptionally large daily loss in the SP500 on August 24th, and ended in October. Our approach eliminated the downside and even had a very small positive impact on return."

Batt: "But to be clear, the main point is that our clients slept well at night and that the pre-defined risk management process delivered what it was supposed to."

Couson: "The second noteworthy hedging period started right at the beginning of 2016 when our signals lead to a full hedge on January 5th. An important component of a disciplined risk management approach is to also include a trigger when to take off the hedge and go long again. In our case this happened in the first few days of March. Again we managed to take out the downside and even contributed to a positive return."

IIN: *Were you able to call the bottom*?

Batt: "You should be skeptical of anyone trying to call the bottom or the top. What our approach is doing, is to quantitatively identify a shift in investor behavior reflected in price and volume data. When is the market driven by greed and when is it driven by fear? Greed and fear are the results of irrational investor behavior and lead to positive and negative trends, on which our approach is based. Hence we do not try to call the peak or the bottom but want to identify a shift in trend very early on."

IIN: *Were you able to call the oil price decline? That was so fast and so steep, it really caught everyone by surprise...*

Couson: "The oil price decline is the perfect example of a shift in price trends which can be identified early on using our models. We had a strong change in sentiment starting mid-2014 followed by a prolonged downside trend, which arguably still persists up to date. Our signals turned negative and indicated a change in the WTI price trend already on the 1st of August 2014 when the WTI future traded at 97.88. Since then we have been advocating a full hedge on the WTI (with a brief exception during the month of June 2015). For any client following our signals, this would have led to more than stellar outperformance."

Batt: "I would add that it is not always such a success story, we know when our models tend not to do as good, namely during sideways markets with short corrections followed by fast rebounds. We experienced this in Q4 2014 and 2015 with certain equity markets. As we see it, these fast V-shaped recoveries from a correction, were also the result of investors expecting the "Yellen Put" or the "Draghi Put" to come to their rescue. Central banks have been stepping in and supported market prices providing, at least from a psychological perspective, the catalyst for fast rebounds and contained volatility. In our view this era is coming to an end and investors should expect more pronounced trends and higher volatility levels than in the past three years. Of course, this would bring back an environment where a clear and systematic risk management approach is central."

To be connected with either gentlemen with Sanostro, please send Content Director Kristen Oliveri and email by clicking HERE.