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## Preparing for the Next 'Black Swan'

*Investors Are Flocking to New Strategies Designed to Profit From a Market Calamity. But Will They Fly?*

By JANE J. KIM



Getty Images

Traders worked the floor of the New York Stock Exchange on Sept. 17, 2008, a day the Dow Jones Industrial Average closed down 449 points.

After a decade-long bear market and two years of turmoil that saw the stock market plunge by 57%, investors are betting on still more financial pain in the months ahead.

Bond yields are near record lows. Gold continues to soar. And stocks are whipsawing as traders try to predict the direction of an economy that remains, in the words of Federal Reserve Chairman Ben Bernanke, "unusually uncertain."

But not every investor is trembling with anxiety over the next financial blowup. Some are embracing the market's volatility—and constructing portfolios to profit from it.

A growing number of money managers and financial firms are rolling out investment products designed to exploit big declines known as "black swan" events. Most of the products are geared toward institutional investors such as pension funds, endowments and high-net-worth families—but black-swan strategies are trickling down to Main Street as well.

The term black swan was popularized in a 2007 best-selling book by author and investor Nassim Nicholas Taleb. It derives from the ancient belief, once widespread in the West, that all swans are white—a notion that was proven false when European explorers discovered black swans in Australia.

The gist: Anything is possible. In fact, big surprises are more common than people think.

In financial terms, a black swan usually results in drastic moves in the market—events such as the 1990 Iraqi invasion of Kuwait, the Sept. 11, 2001, terrorist attacks and the recent financial crisis. Statisticians call these events "fat tails" (because they occur on the fringes, or tails, of a bell curve), while professional investors try to manage their "tail risk."

The basic idea behind Mr. Taleb's black-swan strategy is to keep most of your money ultrasafe, and to bet a small portion—say 10%—on options contracts or other speculative bets whose prices will soar during a market panic.

The collapse of Lehman was a boon to black-swan investing. Funds run by Universa Investments LP, a Santa Monica, Calif., hedge fund managed by Mr. Taleb's longtime collaborator Mark Spitznagel, gained more than 100% in 2008. Mr. Taleb has been an adviser to Universa since it launched in 2007; its assets have swelled during that time to about \$6 billion from \$300 million.

Today, there are as many as 20 hedge funds specializing in tail-risk strategies, most of which have formed in the past 18 months, according to Hedge Fund Research Inc. Capula Investment Management LLP of London and Pine River Capital Management LP of Minnetonka, Minn., are among the firms that have started tail-risk hedge funds this year.

Some of these specialized funds aim to profit when markets tank. Others are designed to protect against a market plunge but still profit when markets rise. Investors don't typically put all of their money into these funds—but they are putting in more these days.

Retail investors are getting more access to black-swan-oriented strategies, too. Bond-fund giant Pacific Investment Management Co., or Pimco, has recently begun using tail-risk strategies in its Pimco Global Multi-Asset Fund, which launched in October 2008; in its RealRetirement target-date funds; and in its new equity funds launched this year. The firm also has filed a registration statement with regulators to offer exclusive "private placement" investments to well-heeled investors using tail-risk hedging strategies.

Some individual investors even are considering setting up black-swan portfolios of their own. "The 2008 downturn got me thinking that black swans can happen and will happen," says Justin McCurry of Raleigh, N.C. The 30-year-old transportation engineer says he is thinking of putting a small portion of his portfolio into options as a way to "limit downside or to pick up some extra money if things went crazy."

### Black Swan (blak-'swan)



[View Full Image](#)

Jack Unruh

An unforeseen event that can wreak havoc on the financial markets.

**-21%**

1987 Stock-Market Crash

(10/16/87 – 12/4/87)

**-16%**

Iraqi Invasion of Kuwait

(8/2/90 – 2/28/91)

**-12%**

Sept. 11 Attacks

(9/10/01 – 9/21/01)

**-19%**

Implosion of Long-Term Capital Management

(7/17/98 – 8/31/98)

**-46%**

Collapse of Lehman Bros.

### Spreading Your Bets

The old cure for extreme events was simple diversification: spreading your bets among a broad array of asset classes. But the financial crisis showed that asset allocation isn't always reliable when markets tumble in unison.

Diversification "works most of the time, but when it doesn't work, those times really kill you," says John Liu, who heads up Citi Portfolio Solutions, a newly formed unit at Citigroup Inc. dedicated to developing and managing tail-risk hedging strategies for institutional investors.

But black-swan investing has its risks, too. The biggest: When markets are behaving normally, the strategy can miss out on a rising stock market—even as costs add up.

That is because the strategy typically involves buying lots of out-of-the-money "put" options on everything from stock indexes and interest rates to currencies. Put options confer the right to sell the underlying instrument if the price falls to a certain level. Because they offer protection, their values soar during market panics, producing big profits for the holders. But if the market doesn't plunge, the options expire worthless, and the investor must buy new options to replace the old ones.

If markets hold steady or rise for long periods, those costs can add up. During the stretch from late 1990 to early 2000 there wasn't a single bear market, commonly defined as a 20% or greater fall from the peak. An investor using a pure black-swan strategy would have missed out on one of the greatest bull markets in history.

Another risk: Because black-swan events are so unpredictable, the markets' reactions to them can be equally unpredictable. Just because an approach worked last time doesn't mean it will work in the future. Some of the new products launched in the past two years might not perform well under duress.

(9/12/08 – 3/9/09)

And Wall Street is always happy to cater to investors' bullish or bearish whims, so long as it can charge fees. "Whenever an investment company tells you that they've come up with a product that can protect you from black swans, you should hold onto your wallet," says William Bernstein of Efficient Frontier Advisors.

Despite the risks, a growing number of professional investors are diving in, whether to protect against a plunging market or to profit from one. Brett Barth, a partner of BBR Partners LLC, a multifamily office in New York, in June started investing client money in Pine River Capital's Nisswa Tail Hedge Fund. "For what we expect to lose on the premium we're spending, we expect to get a big payoff in a tail-risk event," Mr. Barth says.

Similarly, Brinton Eaton, a wealth-management firm in Madison, N.J., earlier this year began using a structured product from Deutsche Bank AG called "Emerald" to reduce its black-swan risk. The instrument, which uses derivatives tied to an index such as the Standard & Poor's 500-stock index, typically does better in periods of higher volatility. It is designed to post small returns in most markets, says Jerry Miccolis, Brinton's principal and chief investment officer. "But in very dramatic times, that bet gets amplified."

Ordinary investors are seeking out black-swan investing opportunities as well. Pimco's Global Multi-Asset Fund, launched in 2008, has attracted \$2.3 billion in assets so far despite its hefty fees for retail investors, including a 1.91% levy for its Class A shares.

Kent Smetters, a risk-management professor at the University of Pennsylvania's Wharton School and president of Veritat Advisors, a Philadelphia-based online financial-planning firm, is working with financial advisers to bring tail-risk strategies to retail investors in a lower-cost mutual-fund vehicle by early next year. "Turbulent markets also provide lots of opportunities," Mr. Smetters says.

Investors wary of paying fees to mutual-fund managers can implement their own tail-risk strategies. In "The Black Swan," Mr. Taleb recommends a "barbell" strategy in which investors put 85% to 90% of their portfolios in extremely safe instruments, like Treasury bills, and the remaining 10% to 15% in highly speculative bets such as options.

That strategy is designed to lose a little bit during most years and to profit handsomely when markets tank. The key to the barbell strategy is knowing what your maximum loss is and being comfortable with it, says Mr. Spitznagel, who has been managing tail risks for more than a decade. Before founding Universa, Mr. Spitznagel and Mr. Taleb ran another black-swan hedge fund, Empirica Capital, from 1999 to 2004.

### Participating in Rallies

To some investors, Mr. Taleb's model might seem extreme. One alternative is to use a hedging technique designed to allow investors to participate in rallies while staying protected during black-swan crashes. "When you eliminate your upside, you really get hammered over time," Mr. Smetters says.

His strategy aims to limit losses to 10% in a market crash but also allow for significant upside potential. To do that, he builds a type of "zero-sum collar" that uses a combination of put options to limit losses and call options to take advantage of the upside. (Whereas puts give investors the right to sell a particular security at a predetermined price, calls give investors the right to buy.) As the market rises, Mr. Smetters says, he cashes in the small gains from the call options and purchases new ones.

#### Profiting From Doom

Investors are adopting a variety of strategies to capitalize on the next market shock.

##### Institutions, Hedge Funds and Wealthy Investors

More are adopting "tail risk" investing, mainly by using options strategies that could generate big profits during a market crash.

Some firms offer structured products that take advantage of volatility. Deutsche Bank's Emerald and Elvis products aim to provide big returns in more-volatile markets but could lose money in bull markets.

##### Retail Investors

Pimco uses tail-risk strategies in its Pimco Global Multi-Asset Fund, launched in late 2008.

Put options can generate big profits during a panic, but can expire worthless during normal markets.

Source: WSJ research

A similar hedging approach involves buying protective puts on stocks you already own in your portfolio. Say you own shares of International Business Machines Corp., which are trading at about \$127.

For about \$7.60 you could buy a put that allows you to sell the stock if the price falls to \$125 at any point in the next five months. That put would likely soar in value during a market rout.

Citigroup's Mr. Liu says investors who want to hedge for a black-swan event can usually keep their existing asset allocations in place as long as they are willing to spend 0.5% to 1% of their portfolio's expected return on the protection.

The Pimco Global Multi-Asset Fund, meanwhile, aims to limit potential losses in any one year to 15% while still participating in market rallies. Co-manager Vineer Bhansali says he tries to keep hedging costs between 0.50% and 0.75% of assets.

The portfolio itself seems fairly conventional. At the end of June, it held 45% in equities, 29% in developed-markets cash and bonds, 13% in emerging-markets bonds and 13% in real assets like commodities and gold, says Kevin McDevitt, mutual-fund analyst at [Morningstar Inc.](#)

Pimco doesn't spend a lot of time forecasting what the black swans might be, Mr. Bhansali says. Instead, it looks at "pressure points" in asset classes that have "gotten substantially out of whack," and buys the cheapest protection possible, from puts and calls on stock indices to options on interest rates and currencies.

Of course, it takes a lot of diligence for ordinary investors to trade puts and calls on a regular basis. Those trades can be especially tough to swallow when markets are going up and options are expiring worthless.

"It's very difficult for traders to engage in a strategy that does very little in the vast majority of markets," Mr. Spitznagel says.

Unlike most investors, he says, "We are prepared to wait a very long time to get a black swan." He adds: "I do happen to believe that more panic is looming."

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