Long-Term Tail Hedging Is Still Cheap

By Vineer Bhansali | April 7th, 2025

While the events of the last week have resulted in a sharp flight out of stocks and a spike in short-term volatility, long-term volatility has barely budged. As a consequence, even credit spreads, though widening a little bit, have barely registered any possibility of a recession and credit defaults. In my view, this provides an unprecedented opportunity for investors to (1) Hedge their portfolios, (2) Prepare for recession remote as it may be, (3) Create the asymmetry that might result in long term opportunities via the generation of liquidity.

As I discussed in two pieces over the last couple of weeks, the market has been too complacent about the current events morphing into something bigger. We are seeing the path-dependency that emerges from large events driving forced reactions from participants. However, the collective mind-set still seems to suggest that investors are betting on a sharp pivot from either the administration or the Fed (to cut rates), or the hopes of trading partners negotiating down mutual tariff rates. This might still happen and would likely be a positive development for markets, but each day of delay is likely to create an acceleration in the selloff in the markets.

In exhibit 1 below we show the level of implied volatility for short expiry (3m) options with an 80% strike (i.e 20% out of the money). A 20% or more selloff is typically known as a bear market. Since 1927 the S&P500 has had 23 bear markets. 16 of these bear markets have been followed by economic recessions. Longer dated volatility tends to rise when the fear of recession looms large.

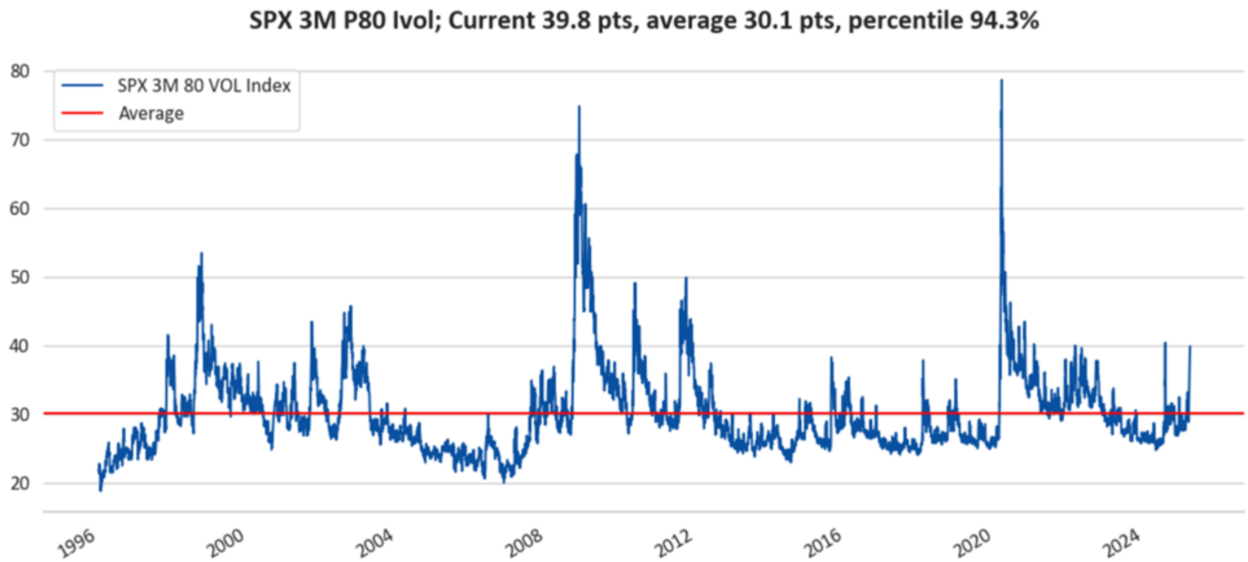

Exhibit 1: Short-dated (3m) implied volatility for a 20% out of the money strike. Source: Optionmetrics, LongTail Alpha.

As seen in Exhibit 2, longer dated volatility has not risen very much at all.

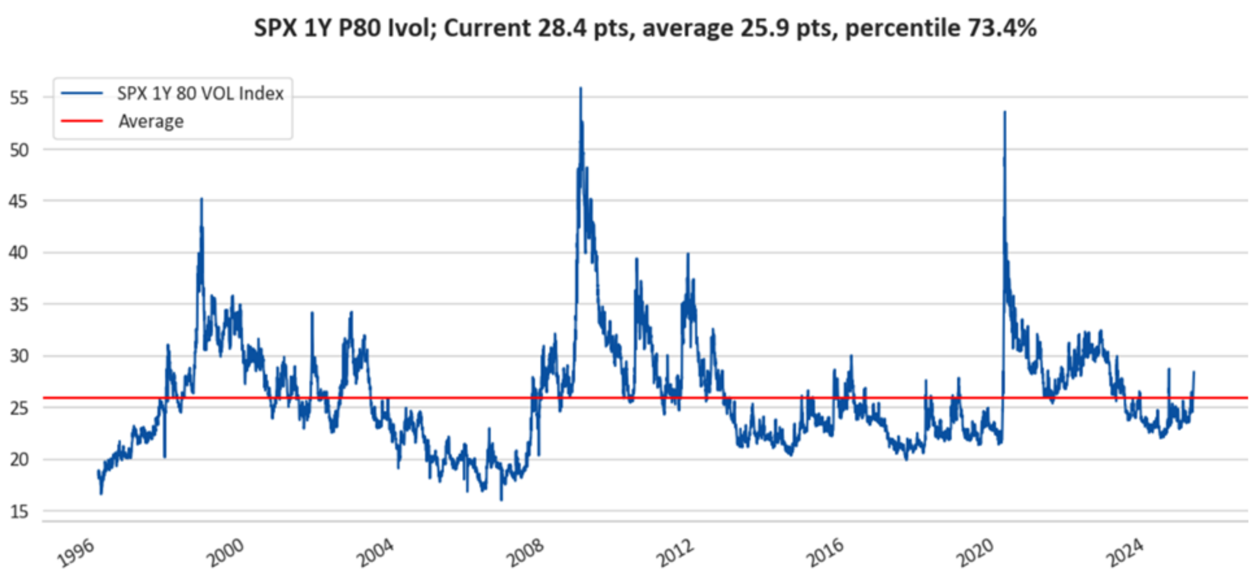

Exhibit 2: Longer-dated (1y) implied volatility for a 20% out of the money strike. Source: Optionmetrics, LongTail Alpha.

Exhibit 3 shows that the spread between short-dated and long dated volatility has reached a historic extreme. In other words, the volatility "curve" is severely inverted. This is a possible symptom of the belief that (1) the shock to the system will revert quickly, (2) in the long term the markets will revert back to normalcy.

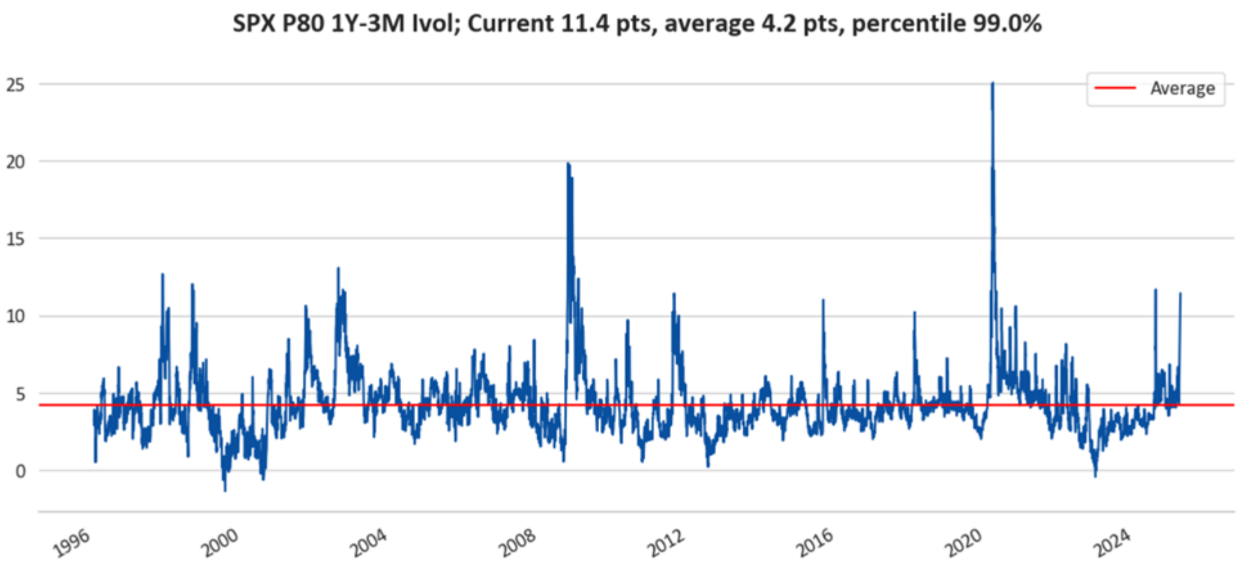

Exhibit 3: Spread of Short-Dated (3m) and Longer-dated (1y) implied volatility for a 20% out of the money strike. Source: Optionmetrics, LongTail Alpha.

However, if the current selloff continues and morphs into an actual recession or recessionary fears long dated volatility can start to rise. A recessionary fear driven increase in longer dated volatility tends to be persistent. This is because longer dated equity volatility is the building block for the pricing of corporate bond spreads. As long dated volatility rises, credit spreads can start widening, which can in turn result in a self-fulfilling feedback. As credit spreads widen, companies find it difficult to borrow at attractive rates, and have to cut back on expenses. In the worst case scenario, they might even have to start laying off employees, which can result in actual economic damage that could turn into a vicious cycle of persistent and semi-permanent condition. Historically these conditions are met with aggressive Central Bank easing and fiscal stimulus. However, given that inflation is still higher than the Fed's objectives, this easing decision might not be as easy and immediate as in past cycles.

In Exhibit 4, we show the pricing of a 1 year 20% out of the money put option. It is clear that despite the events of last week, the pricing of tail hedges has not moved into expensive territory yet. In our view, it is impossible to tell whether the markets will stabilize or not. Faced with this uncertainty and the increasing path-dependency of the global geopolitical reaction function, this might not be a bad time to initiate longer dated hedges for portfolios that are exposed to recessionary fears.

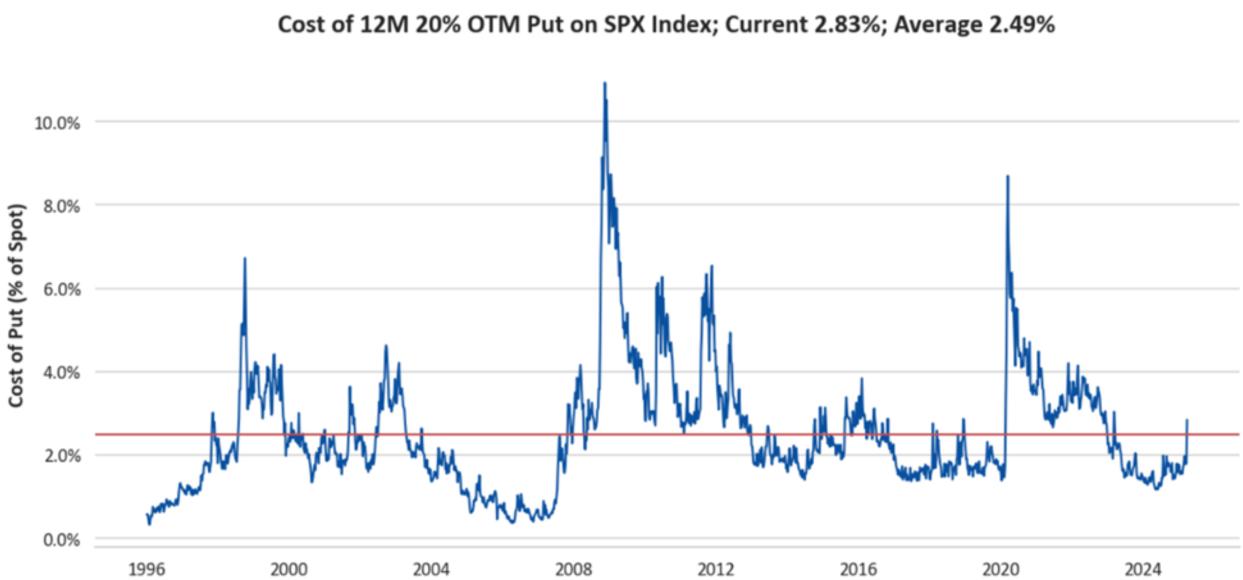

Exhibit 4: Price of a 20% out of the money put option on the S&500 index. Source: Optionmetrics, LongTail Alpha.

Important Disclosures

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