Crash Insurance: Short-term Put Hedging Strategy

The volatile environment makes it difficult to cheaply hedge crash risk. The traditional way of putting on naked shorts becomes more complicated as volatile daily moves mean we have to place our stops wide, in order to stay in the hedge. A wider stop equates to a much smaller hedge, which obviously isn't ideal. In addition, the high volatility means buying long-dated puts or running our "50 Cent Strategy" are out of the question, as we'd burn too much in premium.

Luckily, there's another little-known option. One that is routinely mispriced (read: cheap) and insensitive to implied volatility, yet still offers tremendous asymmetry when there are significant realized moves.

A terrific options trading book titled The Second Leg Down by Hari Krishnan gives us some insight into how we can do this.

The strategy relies on buying out-of-the-money (sub 25 Delta) put options with four days or less days until expiration. We are intentionally choosing intra-week options since these give us exposure over time horizons where the underlying distribution has the heaviest tails. And historically, institutional managers favor hedges with a few months to maturity.

It's uncommon to see strategies that require rolling weekly options. But this strategy has the benefit of being very capital efficient. It's not unusual to make 15x or more on your costs.

This allows us to risk a very small amount (less than 20 basis points [bps]) and still be protected from a notional point of view. It's important to point out that this strategy needs to be applied with discretion (when data suggests crash risk is high). And is only useful during periods of high volatility where other approaches to hedging are too costly and inefficient.

We don't know whether the seasonality / sentiment-driven-reversion bear market rally will kick off soon, or if at all. But we do know from the data and the way the tape is acting, that crash risks remain high – not to mention the numerous potential geopolitical shocks currently brewing…

Because of this, we'll be employing this strategy soon. And we'll be rolling these options weekly, as long as the data says it makes sense to do so. We'll be buying Out-of-the-Money Puts (≤ 25 Delta) with ≤ 4 days to expiration, and we'll be risking no more that 15 bps per hedge.

Our book is already hedged with our high cash position, Nasdaq short, and our USDCNH longs (USDCNH should continue to run as risk-off dominates). But in a crash scenario, cross-correlations go to 1. Running this short-term strategy will help ensure our book makes money in such a scenario.

Your Macro Operator,

Alex

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