CIO Brief

When Hedges Work – And Still Fail

Why unrealised protection doesn't change outcomes, and what CIOs can do about it

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1. Executive Summary

Institutional portfolios rarely suffer because their hedges are wrong.
They suffer because nothing happens when those hedges are right.

Across FX, rates, credit, and equity portfolios, hedges routinely perform exactly as designed. Mark-to-market gains accumulate, volatility metrics improve, and governance bodies are reassured that protection is in place.

Yet in most cases, those gains are never converted into usable capital, re-locked protection, or improved portfolio resilience. They are observed, reported, and then quietly given back.

This brief argues that the problem is not hedging technique. It is the absence of a monetisation doctrine.

An unrealised hedge gain is not protection. It is an unmade decision.

This is not a call to trade hedge books more actively. In practice, institutions with clear monetisation rules often trade less, because decisions are batched into predefined trigger events rather than debated ad hoc.

The objective is simple: ensure that when protection appears, it can change outcomes.

Any numerical examples are illustrative and reflect realistic institutional conditions.

2. The Hedge That Worked – And Still Failed

A long-term institutional investor holds a substantial foreign-currency asset. The exposure is strategic and persistent. The mandate is clear: reduce FX volatility, not generate FX alpha.

A rolling FX forward programme is implemented to hedge a fixed portion of the exposure. The structure is liquid, accounting-aligned, and fully approved. Reporting shows volatility reduction. The hedge is working.

Over time, FX moves materially in the fund's favour. The hedge moves deep in-the-money. Mark-to-market gains accumulate steadily.

No action is taken.

There are no monetisation triggers, no authority to crystallise partial gains, and no re-hedging doctrine. The prevailing view is simple: "We're hedged. The hedge is doing its job."

The currency eventually reverses. The accumulated gain compresses, then largely disappears. Carry costs persist throughout. The opportunity to re-lock protection at materially better levels passes.

The hedge worked. The portfolio is still worse off than it should have been.

The failure was not market timing.
The failure was structural inaction.

This pattern is not rare. It is systemic.

3. Why This Happens in Otherwise Well-Run Institutions

This failure is not driven by incompetence or poor intent. It is driven by institutional design.

Three forces dominate.

Career Risk Asymmetry

Monetising a hedge gain feels like trading. Staying hedged feels like prudence.

When a hedge is visibly "working", altering it is harder to defend than leaving it untouched. Over time, this creates a bias where give-back is tolerated, but crystallisation is viewed as discretionary risk.

Inaction feels safer than action, even when action would improve outcomes.

Measurement Mismatch

Hedge P&L is reported monthly or quarterly. Committees meet monthly or less frequently.

But monetisation opportunities often exist for days, hours, or even minutes. Equity volatility collapses quickly. Credit spreads retrace after intervention. FX mean-reverts within weeks.

The instruments move faster than governance.

Optionality Worship

Keeping a hedge in place preserves the appearance of protection. Monetising it creates a new decision point: do we re-hedge, and how?

Many institutions prefer to preserve optionality rather than exercise it, even when exercising it would lock in gains. The cost of optionality – carry bleed, decay, or give-back – is treated as invisible.

The result is predictable: hedges are left untouched until their value disappears.

In modern derivatives portfolios, the cost of this design failure increasingly shows up not as give-back, but as liquidity stress.

4. When the Cost Is Liquidity, Not Just Give-Back

In modern derivatives portfolios, the cost of inaction is not limited to lost gains. It increasingly shows up as liquidity stress.

Consider a portfolio with cleared rate and FX hedges. Markets move favourably. Hedge MTM gains accumulate. At the same time, other positions generate variation margin outflows.

Treasury manages the cash drain. Investment teams point to hedge gains as reassurance.

But the gains are unrealised.

They cannot be used to meet margin calls. They cannot be redeployed. They cannot relieve liquidity stress without monetisation authority.

The organisation bleeds cash while sitting on paper protection.

Eventually, assets are sold, facilities are drawn, or opportunities are missed. When markets reverse, hedge gains compress, and the liquidity pain has already been paid.

The hedge was right.
The organisation still suffered.

This is the variation-margin trap, and it is a direct consequence of treating hedging and liquidity as separate governance problems.

5. What a Monetisation Doctrine Actually Changes

A monetisation doctrine does not mean trading hedges aggressively. It means defining, in advance, how protection is converted into outcomes.

At a minimum, it requires:

- **Explicit triggers** that mandate evaluation when gains reach meaningful levels
- **Delegated authority** aligned to the speed of the instrument
- **Procedural re-hedging logic** so monetisation does not create exposure gaps
- **Integration with liquidity planning**, not separation from it

The objective is not perfect timing. It is reducing structural give-back and ensuring that protection is usable when it matters.

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In practice, this means fewer debates, fewer missed windows, and clearer accountability.

One principle matters more than any other:

If your hedge P&L volatility exceeds your operational decision-making speed, you don't have a hedge – you have a management problem.

Institutions that implement monetisation rules typically discover that:

- fewer decisions are debated
- fewer opportunities are missed
- and hedge outcomes become measurable, not theoretical

6. A CIO Diagnostic

A simple test:

1. What percentage of hedge MTM gains have actually been crystallised over the last five years?
2. Can the CIO monetise 50% of a hedge position without board approval?
3. Have hedge gains ever been used deliberately to relieve liquidity stress?
4. Do written rules exist for when a hedge gain must trigger evaluation?
5. Can you point to a documented instance where a hedge gain was monetised *before* the risk that created it had fully played out?

If these questions are uncomfortable, that discomfort is the signal.

7. Closing

Modern portfolios are complex, long-dated, and governed by layers of process designed to reduce risk. But without a doctrine for monetising protection, those same processes ensure that hedge gains remain theoretical.

This is not a failure of intent, skill, or sophistication. It is the predictable outcome of default institutional settings.

Hedges that cannot be monetised when they work do not reduce risk – they defer it.

Most institutions believe they are conservative because they do not trade their hedge books. In practice, they are conservative because they allow hedge gains to evaporate by default.

If your hedges exist but your monetisation doctrine doesn't, we should talk.

Further Reading and Practitioner Resources

Para Bellum Advisors publishes practitioner papers and CIO Briefs: www.parabellumadvisors.com/insights.

About Para Bellum Advisors

Para Bellum Advisors is an independent advisory firm specialising in derivatives, collateral, and balance-sheet efficiency for institutional investors.

The firm works with lean investment teams managing complex, long-dated portfolios across FX, rates, credit, equity, and volatility risk. Its focus is not on product distribution or transaction volume, but on structure: how hedges are designed, how capital is consumed, and how portfolios behave under stress.

Para Bellum Advisors is practitioner-led. Its work draws on decades of experience across trading, structuring, and portfolio management in banks, asset managers, and insurance balance sheets. The objective is not theoretical optimisation, but durable improvement in capital efficiency, liquidity resilience, and realised outcomes.

For more information, visit www.offers.parabellumadvisors.com

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