



PARA BELLUM ADVISORS

EXECUTIVE BRIEF

# When Convexity Matters Most

## How Tail Hedges Become Liquidity When Portfolios Break

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### Executive Summary

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Most tail-risk programmes are judged on the wrong metric. They are evaluated on mark-to-market gains, not on whether they deliver usable cash when the portfolio needs it most.

That mistake turns convexity into pointless drama. A tail hedge is not a view on markets. It is a liquidity instrument whose sole job is to convert crisis dislocations into cash fast enough to stabilise the portfolio and position it to emerge stronger.

Institutions that fail to pre-commit how and when that conversion happens usually discover the problem too late.

### The Core Error Boards Keep Making

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Boards rarely set out to misuse tail hedges, but they often frame them incorrectly. In practice, tail-risk programmes are treated as static allocations, philosophical statements about risk aversion, or insurance sleeves intended to be held until expiry. Each framing misses the point.

Convexity is a wasting asset. Once policy intervention arrives, liquidity returns, or market structure normalises, the value embedded in tail hedges begins to decay rapidly. Volatility mean-reverts, bid-offer spreads compress, and instruments that looked powerful at the trough can quietly bleed value while the core portfolio remains impaired.

*Judging success by mark-to-market gains is a category error. Marks do not fund redemptions, margin calls, collateral requirements, or operating expenses. Cash does. A hedge that is never monetised is not protection. It is an unrealised idea.*

## What Success Actually Looks Like

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A tail-hedge programme can only be considered successful if it delivers outcomes in real time, not explanations in hindsight.

It must act as a liquidity bridge, funding a defined runway of obligations under explicitly stressed assumptions. It must contribute to drawdown containment, with realised hedge proceeds offsetting a material portion of contemporaneous losses at pre-agreed thresholds. It must preserve the option to act; cash raised from convexity should first stabilise the balance sheet and only then, if conditions allow, support selective re-risking into assets the institution would be comfortable holding for years.

*If realised proceeds are not multiple turns of annual carry, the programme is not insurance. It is cost.*

## Why Discipline Beats Judgement in a Crisis

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Crises do not wait for agendas, memos, or committees. Institutions that execute well under stress share one characteristic: authority, triggers, and choreography have been agreed in advance. Action does not rely on judgement calls made at the peak of uncertainty.

Effective frameworks define three independent trigger lenses that can each authorise monetisation on their own. Portfolio-level triggers link staged hedge realisation to drawdown thresholds as losses accumulate. Hedge-level triggers focus on the coverage the hedge is providing relative to contemporaneous losses. Market-structure triggers recognise that convexity decays fastest when policy intervention, term-structure shifts, or liquidity restoration occur.

*When these triggers are pre-approved, execution becomes mechanical rather than heroic. The objective is not to maximise gains, but to ensure that cash is raised while it still exists.*

## What Boards Underestimate: Decay and Market Plumbing

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Not all tail hedges behave the same way once the shock passes. Equity convexity pays early but decays quickly as policy support and liquidity return. Credit protection holds value longer but introduces basis risk when markets are thin. Rates hedges monetise fast and compress just as fast once backstops appear. Cross-asset overlays can provide liquidity when option markets seize up but can whipsaw as correlations shift.

The governance implication is unavoidable. Tail-risk programmes must be diversified across drivers and laddered across maturities, with at least one sleeve designed to pay early and fund the rest of the plan. Owning convexity is easy. Turning it into usable cash under stress is not.

## The Monetisation Mistake That Destroys Value

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The most common value-destroying behaviour is waiting for the right moment. Perfect exits do not exist in dislocations. Attempting to identify them usually results in doing nothing while decay accelerates. This is why experienced programmes monetise in tranches rather than all-or-nothing.

Early tranches reduce regret and secure liquidity. Later tranches manage decay as conditions normalise. Residual hedges protect against second-leg risk. This approach is not a lack of conviction. It is realism encoded into policy.

## Why Proceeds Discipline Matters More Than Hedge Selection

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Most governance failures occur after the hedge has worked. Cash feels powerful. Teams feel vindicated. The temptation to redeploy aggressively overwhelms balance-sheet discipline. This is precisely why the use of proceeds must be codified before the event.

Liquidity obligations come first. Balance-sheet ballast comes second. Opportunities, if any, come last and must be staged. If this hierarchy is not written down, it will not be followed under stress.

## The Policy Sentence Most Boards Wish They Had

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The governance language that makes monetisation operational rather than aspirational:

*When predefined drawdown or hedge-performance thresholds are reached, the CIO is authorised to monetise the tail-hedge programme in staged tranches without convening a meeting. Proceeds first extend the institution's liquidity runway and strengthen defensive capacity. Only after this may pre-approved opportunity baskets be funded gradually. A residual hedge is re-established to protect against second-leg risk.*

## Closing Perspective

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Most institutions do not fail because they lacked convexity. They fail because they lacked authority to monetise it, triggers to force action, and a clear purpose for the cash once it arrived. The result is predictable: impressive marks, disappointing outcomes, and post-mortems filled with conditional language.

Tail hedging is not about predicting crises. It is about ensuring that when markets seize up, the institution has the one thing nobody sells cheaply: time. Time comes from cash. Cash comes from disciplined monetisation. Discipline only exists before the crisis arrives.

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## About This Brief

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This Executive Brief is a companion to the Para Bellum Advisors practitioner paper: Turning Convexity into Cash – The Discipline of Active Tail Hedge Management.

Available at [www.parabellumadvisors.com/insights/](http://www.parabellumadvisors.com/insights/)

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## About Para Bellum Advisors

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Para Bellum Advisors is an independent advisory firm specialising in derivatives, structured finance, and balance sheet efficiency for institutional investors, family offices, and corporate treasury teams.

The firm focuses on hedge framework design, overlay mechanics, collateral efficiency, and portfolio resilience across FX, rates, credit, equity, and volatility exposures. Its work is practitioner-led, drawing on three decades of experience across trading, structuring, and portfolio management in APAC and globally.

Para Bellum Advisors is independent of product distribution and transaction mandates. Its objective is durable improvement in capital efficiency and liquidity resilience.

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