JULY 2026

36 South Views

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Interesting mentors

The market seems to find new levels of craziness every month with no let-up in rampant bullishness. The Korean market takes centre stage as it suffers 1929-like falls amid massive retail liquidation. Will it be contagious?

Who knows, but as Dennis Gartman said once, “There is never just one cockroach”[1].

I also realised this month that tail risk hedging is viewed as an exercise in futility. On one level, I agree. Governments are way past the point at which they would do the right thing and curtail spending to rein in their excessive debt. In spite of rising yields, bond vigilantes and the like, they will carry on regardless.

Monetary inflation is probable; if anything, hedge the right tail, not the left.

So why put on a tail hedge when the market is destined for higher and higher levels?

This is the $64,000 question.

Firstly, do you have the wherewithal to hold your and your clients’ portfolios firm when the market is down 60%?

Secondly, will you have the wherewithal to ADD to your investments when there is “blood in the streets”?

The answer is generally *NO* in both cases when you don’t have a tail hedge in place, and *YES* when you do have a tail hedge that you monetise and spend the proceeds on beaten-up assets.

The increase in compounded portfolio growth rate when you do these two things massively outweighs the small premium you forgo during the in go-go years of tail risk hedging.

Thirdly, if the market goes down and stays down, you lose TIME. Japanese investors might have been made whole now after the Nikkei crashed in the 1990s, but they have lost so much compounding time. If they had had a tail hedge, they would be compounding from a much lower base, and their compounded growth rate would be so much better.

Fourthly, inflation is the most likely outcome, but it is not 100% certain. Depression, war and natural disasters cause deflation, which can exist for years in the absence of massive government intervention.

A tail risk hedge blunts the brute-force trauma on a portfolio, especially in these circumstances.

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[1] Dennis Gartman – The Gartman letter

But you won't "feel" the value of a tail risk hedge until you need it. That is why one of my savviest clients calls me the "Titanic life-raft salesman."

They understand how much value a pre-bought spot on the life raft would be if a Titanic-style tail event were to occur and they were on it.

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