SWAN GLOBAL INVESTMENTS

Keep Calm and Hedge

Why Hedge Your Investments

David Lovell | July 7, 2018 | Swan Insights

What comes to mind when you hear the word "hedge"? Hedge funds? Scandals? High risk? Leverage? Fraud?

Hedging gets a bad rap. This is unfortunate because it can be an important risk management tool for investors.

What the Hedge?

Hedging does NOT equal hedge fund. Often, the purposes of the two are at odds with one another.

Typically, one hedges to reduce the negative impacts of market risk and volatility in a portfolio. The hedge is intended to offset potential losses by transferring risk in various ways (e.g., options, shorting, or futures contracts).

Say that again? Hedging seeks to reduce and manage risk.

Hedge funds' bad reputation often stems from them taking riskier positions to increase returns by hedging and/or leveraging (borrowing money to place market bets). These riskier positions are at odds with the stated goal of hedging alone.

Hedging Is Nothing New

Hedging has been around a long time. Farmers, airlines, banks—they all hedge to manage the biggest risks in their businesses. Farmers hedge against changes in seed, livestock and crop prices. Airlines hedge against big changes in oil prices. Banks hedge against interest rate risk.

If you own car or home insurance, you are essentially hedging against potential property loss either due to a car accident or housing catastrophe.

Diversifying your portfolio can sometimes appear like a form of hedging. For example, many investors buy bonds to offset potential losses in stocks with the expectation that bonds, and stocks are uncorrelated and won't move in the same direction at the same time. This, however, hasn't always been the case. Remember the 2008 Financial Crisis? Many types of bond funds lost value at the same time as nearly every category of stocks.

According to Investopedia, "market risk…cannot be eliminated through diversification, though it can be hedged against." Diversification alone isn't enough to manage market risk.

Protect Your Assets

As hedging is meant to reduce risk and volatility, the goal is to lose less money in your investments, especially during times of major market stress. If your portfolio spends less time recovering, it may spend more time compounding.

Some common ways to hedge involve market timing, short selling, futures contracts, and options.

Marketing timing and short selling depend on one's ability to successfully and repeatedly "predict the market." It is difficult to consistently time when to buy or when to sell across all holdings in a portfolio, making this approach an undependable risk management approach.

Put options, on the other hand, may be a good option for those looking to protect their assets from inevitable, but unpredictable times of major market stress.

Keep Calm and Hedge

You know investing can be a bumpy ride. Hedging may be a way to create a smoother ride.

The key to a hedging strategy is to take an uncorrelated offsetting position relative to some asset (stock, etc.).

Put options on an asset are especially effective for hedging since a put option is inversely correlated to the asset itself. For example, when you use a put option on a stock, if the stock price goes down, the value of the put option goes up, and vice versa.

We believe that put options are much more effective in managing and reducing risk than other forms of hedging. They offer control over the hedging process, are inversely correlated to the asset they seek to protect, may reduce adverse investor behavior, and offer profit potential.

Some may shy away from mutual funds or other investments that use options due to unfamiliarity with options or their capabilities. Hedging, however, offers a direct way to address market risk. A hedged equity approach defines and manages risk via put options may be beneficial for investors who want to:

- Remain invested
- Reduce overall portfolio risk
- Seek protection in times of major market stress

Market risk is too important of a threat to be dealt with passively.

Win by Not Losing

Hedging doesn't have to be only for airlines and banks. Investors should consider incorporating a hedged equity strategy in their portfolios to help manage and balance the risk from other investments. But how does one vet and select a hedged equity strategy?

A hedged equity strategy should have the following attributes:

1. Its main goal is to reduce and manage market risk.
2. It has a transparent and rules-based strategy.
3. The strategy has weathered times of major market stress.

The goal of our Defined Risk Strategy, a hedged equity approach, launched in 1997, is to produce consistent returns through ups and downs of the market. By tackling market risk head on, the Defined Risk Strategy seeks to help investors remain always invested for growth, while remaining always hedged to reduce losses in times of major market stress.

About the Author:

David Lovell, Director of Marketing, is responsible for Swan's marketing and engagement initiatives. This includes development and execution of marketing programs for Swan's websites, content, communications, events, and media. David began his career in the financial industry at Mass Mutual. David currently holds a Series 65.

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