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An ETF for the Cautious Investor

An ETF for the Cautious Investor might sound like a funny concept since many finance people think of ETFs as a Cautious Investor tool. Just taking passive (beta) exposure across a broad, diverse group of stocks like the S&P 500 or MSCI World Index may provide some diversification and, over time, likely provide long-term positive returns if history is an indicator of future behavior.

If you bought an S&P 500 Index ETF 25 years ago – January 1, 1996 – your average annual return minus fees would be approximately 7.5% annually, through January 1, 2021. There would be several years when your returns were negative and other years with double-digit gains.

Well, the Cautious Investor would be pretty unhappy in down years and, even worse, may ask you to sell during the worst of times of the drawdown and then not buy back in until the index reached the previous highs. The Cautious Investor's goal could be: Stay invested for returns while avoiding significant losses and setbacks to my financial plan.

	Hedged Equity-HEGD	Buffered ETFs	Tail Risk Hedge
Upside Potential	Uncapped	Typically Capped	Uncapped
Hedging Method	*Puts (LEAPS), Put Spreads*	*Puts Spread Collars*	*Tail risk hedge, typically smaller position, OTM*
Hedging Duration	*1-2 years (typically)*	*1 year (typically)*	*Various*
Risk Management Style	*Active*	*Passive*	*Passive*
Downside Mitigation	Hedged	Buffered	Hedged
Investment Horizon	Perpetual	12-month	Perpetual

Investing Today

In today's environment, many are looking for other ways to do just that. Options and options-based strategies are gaining a lot of attention. In 2020, 25.55 billion futures contracts were traded worldwide, up from 12.13 billion in 2013, according to Statista.

However, in the age of the GameStop drama, the use of options, and in particular the concept of hedging, has been associated with "evil" hedge funds. That is unfortunate, as options are simply investment tools, which can be used in different ways by traders or within a long-term portfolio, such as to seek enhanced returns or to offset losses (hedging).

Options Explained

What are options, and what exactly is hedging, and are they only tools for professional investors? Options are simply contracts. And like any contract, there are two parties involved, a buyer and a seller. Options give either party the right, but not the obligation, to buy or sell a given asset at a certain price (strike), within a certain time frame (expiration). All options contracts are comprised of either calls or puts, which are either held individually or are used in various combinations – using different price levels or time frames (short-term or long-term) – to create different desired results. For more on options, see the Cboe Options Institute.

Call options could be used as a tool for investors who may feel the market undervalues a current stock or asset. In that case an investor could buy a call option on that asset at a higher future price, locking in today's price for the cost of the contract, without having to buy all of the asset at today's price. If the asset increases in price over the term of the call option contract, the investor can make additional returns, but if not, then the investor loses the fixed price of the call option.

In contrast, investors can use put options when they feel like the market currently overvalues an asset. Holding a put option contract enables one to "lock in" the sale price of an asset – and effectively force another party to purchase the asset at a set, pre-defined price. It is important to note that the put option rises in price when the asset falls, and vice versa. So if the asset falls in price, the holder of the put option could sell the contract and offset some or all of the asset's losses – what's known as hedging the asset.

Income Challenges

With low interest rates making bonds less attractive from a return perspective, investors are forced to find new ways to drive portfolio returns, while managing portfolio risk. As such, hedging strategies are growing in popularity.

Now there is a new class of Hedged Equity ETFs blazing a trail in which hedging is used for "good" to provide a buffered downside by utilizing a hedging strategy to limit the impact from significant market drawdowns.

Morningstar has created a broader "kitchen-sink" category of options-based strategies. Within that catch-all category there are essentially three groups of strategies that seek to use options to primarily serve different objectives: to hedge, to generate income, or to provide alpha in some manner. In the hedging group, one can see essentially three types: hedged equity strategies, buffered strategies, tail risk strategies.

Deep Dive

Because there are many hedged equity products, we choose the namesake ETF – HEGD, to do a deep dive, to show how this active manager uses passive ETFs to hold a long position and then uses two forms of options to 1) create a hedge and 2) try to offset the hedge cost.

While hedged equity products can be both active and passive, we thought profiling a risk-managed US Large Cap Active ETF would better highlight the "hedging for good" concept that might appeal to the Cautious Investor. Other hedged equity products can use a selection of stocks or other indexes; they can use different hedging methods and hedging duration periods, and various risk management styles.

HEGD Profile

The Swan Hedged Equity US Large-Cap ETF invests about 90% of its assets into an S&P 500-style (cap-weighted) US large-cap ETF for the bulk of its equity exposure. It then invests in long-term put options, generally 1-2 years in duration, for hedging purposes. The last component is primarily a combination of calls and call-spreads, seeking additional return to help offset the hedge cost, like a "hedge on the hedge." HEGD combines a passively held equity ETF, with an actively managed long-term hedge and options strategies. HEGD intends to hold its ETF portfolio indefinitely while the options are bought and sold based on market conditions. Rebalancing the equity and hedge position occurs annually, seeking to keep a roughly 90% equity allocation. The fund's investment philosophy is to stay invested and to stay hedged (protected), which sounds pretty cautious to me.

What's Unique

The Hedged Equity ETF is unique in its use, and active management, of this long-term put hedge. Most hedged strategies use shorter-term hedging intervals, like 90 days, and passively hold those positions until expiration. HEGD is hedged using much longer put options, longer than the typical bear market even, to not be under pressure to seek protection when the markets are in free fall. The manager's active hedge approach also sets it apart. After big moves, the fund seeks to reset the hedge – raising the hedge level underneath big market up moves and using large market drawdowns to monetize its long-term hedge position to buy additional equity shares at lower prices, while resetting the hedge.

For example, let's say in a sell-off of 20-30%, the fund can sell what would be a valuable 2-year put-option for a premium and then reset the hedge. Any remaining proceeds are used to buy more large-cap ETF shares. This resetting of the hedge during a significant drawdown is something this money manager has done repeatedly over the last 24 years, running this strategy in other funds or SMA wrappers. This strategy aims to provide more consistent risk-adjusted returns, which aligns with the Cautious Investor's goals.[1] AH

[1]S&P 500 calculator - DQYDJ.com

The fund's investment objective is to seek long term capital appreciation while mitigating overall market risk. The fund is new and has a limited operating history.

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