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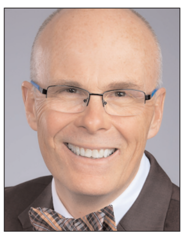
ON DEFENCE

To hedge or not to hedge? It is no question!



Keith Richards

Markets are at an interesting juncture right now. Trade talks are stalling between China and the United States. Mexico is under the gun for controlling illegal immigration to the U.S. – and the EU is struggling with both its own individual elections, and the shape of Brexit.

Meanwhile, the stock market is not exactly in the early stages of its bull market – one might argue that North American markets could be a bit long in the tooth – and in need of a cyclical correction, if not a bear market.

Let's assume you own a portfolio of stocks, and are concerned about losing the gains you've made in recent years.

You have a few choices to reduce your exposure to a declining market. One is to rotate into sectors that are more defensive. Another choice is to reduce overall exposure to the markets. Let's look at two strategies for reducing (but not eliminating) your exposure to market downside.

You can:

-Raise more cash (the Equity Platform is currently 17 per cent cash) or

-Hedge by creating "artificial" cash.

Everyone knows how to raise cash. By selling stocks in your portfolio and not reinvesting them, you raise cash, which obviously cuts your exposure to market movements, whether up or down.

But many investors are unfamiliar with portfolio hedging. Let's look at how "hedging" works. For a more detailed explanation, you can also check out my blog post on this strategy at https://www.valuetrend.ca/hedging-portfolio-risk/

How hedging works, in plain language

At ValueTrend, we have hedged our Equity Platform in the past when we felt that greater market risk was likely. To hedge market risk, we tend to use either single (non-leveraged) inverse ETFs or similar bear-market strategy ETFs.

Firstly, let's assume that the ValueTrend platform is performing exactly in line with the stock market. This is called "beta 1.0". If the market goes up 10 per cent, we make 10 per cent. If it falls 10 per cent, we lose 10 per cent. We tend to have lower volatility than the stock market. But, let's make this 1:1 risk-to-return assumption for this exercise.

If we raise 20 per cent cash by selling stocks – we have 20 per cent less upside, and 20 per cent less downside than the market. All things being equal – cash reduces the movements (up or down) in your portfolio.

Now, let's try something different. Let's hold 10 per cent in cash…and hold the other 10 per cent in a hedge ETF like a single inverse index ETF.

Put simply, hedge ETFs move almost exactly opposite to the market. They go down in up markets, and up in down markets. The price of a single inverse ETF does have some inefficiencies built into it, given the fees and the daily reset pricing (you can research these at the various websites of the ETF providers--and you should do so before buying them!). But a well-managed single inverse ETF is actually pretty efficient.

For example, take a look at the long-term chart of the **Horizons BetaPro S&P 500 Daily Inverse ETF** (HIU-TSX, $26.08) versus the S&P 500 below. Note how this ETF (the line beginning at the top-left of chart) accurately reflects the inverse movements of the S&P 500.

You can see that it went up while the S&P 500 (the line that begins at the chart's centre-left) fell, and vice versa. Right now, while markets fall, it's going up.

In fact, the line at the bottom of the chart is a "correlation" line. You can barely see that line, because it resides at the bottom of its pane, where the perfect -1.0 relationship is reflected. The HIU ETF hovers at around -1.0 to -0.98 most of the time. This means that it has a perfect, or nearly perfect, negative relationship with the S&P 500's movements.

That's what we want to see in an inverse ETF. Note that I am referring to single inverse ETFs in this discussion. You will find two-times, three-times, and higher inverse ETFs. These are highly leveraged vehicles with higher fees and much greater volatility due to reset risks. Those vehicles are best for short-term speculators.

We don't KNOW if markets will fall or climb. We just want to reduce risk for short periods of time. The problem with selling stocks to raise 30 per cent cash happens if the market moves up; now you have to re-buy stocks at a higher price…

With a hedge ETF—you simply create an artificial cash allotment to reduce your volatility. The chart below shows that we would have to hold 30 per cent cash to have the same effect as holding 10 per cent of your portfolio as cash and 10 per cent in a hedge ETF.

With the 10 per cent hedge, 10 per cent cash strategy, you achieved the same level of reduced volatility as if you had 30 per cent cash. But you only needed to have 20 per cent of your assets out of the market – thus, you avoided selling 10 per cent of your stocks.

Note that the chart is for illustration purposes only. Actual results will vary – given the inefficiencies of fees, bid/ask spreads on your trades, and daily resets.

% Held In Hedge ETF	% Held In Cash	Portfolio If Market Up 10%	Portfolio Value If Market Down 10%
0%	0%	$1100	$900
0%	20%	$1080	$920
0%	30%	$1070	$930
10%	10%	$1070	$930

When would we use the hedge strategy?

Technically speaking, there are two times we hedge.

If the market looks to have broken an important support level, we might buy a hedge position to offset some of the potential risk.

Otherwise, if the market shows signs of topping and rounding over, we might buy a hedge position to neutralize some of the portfolio.

Keith on BNN Bloomberg

Tune in to BNN Bloomberg on Thursday, June 20 at 6 p.m. to catch Keith live on the network's premier call-in show, Market Call, where viewers like you can ask his technical opinion on the stocks you hold.

Call in with questions during the show's live taping between 6 p.m. and 7 p.m. The toll-free number for questions is 1-855-326-6266.

Keith Richards is Chief Portfolio Manager & President of ValueTrend Wealth Management. He can be contacted at info@valuetrend.ca. He may hold positions in the securities mentioned. ETFs mentioned are not suitable for investors that are not interested in short-term trading and do not have good investment knowledge. The ETFs mentioned may have exposure to aggressive investment techniques that may include leveraging, which magnify gains and losses and can result in greater volatility in value and be subject to aggressive investment risk and price volatility risk. ETFs are not guaranteed, their values change frequently, and past performance may not be repeated. Please read the prospectus before investing. The information provided is general in nature and does not represent investment advice. It is subject to change without notice and is based on the perspectives and opinions of the writer only. It may also contain projections or other "forward-looking statements". There is significant risk that forward looking statements will not prove to be accurate and actual results, performance, or achievements could differ materially from any future results, performance, or achievements that may be expressed or implied by such forward-looking statements and you will not unduly rely on such forward-looking statements. Every effort has been made to compile this material from reliable sources; however, no warranty can be made as to its accuracy or completeness. Before acting on any of the above, please consult an appropriate professional regarding your particular circumstances.