YOUR 5-MINUTE GUIDE TO HEDGING

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KEITH FITZ-GERALD RESEARCH

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KEITH FITZ-GERALD
RESEARCH

Letter from Keith

Dear Reader,

Millions of investors have watched in horror as their portfolios have gotten vaporized.

Many are desperate to protect everything they've worked so hard to save and invest. Others simply want to avoid further losses and seeing their dreams of financial security vanish over the horizon.

You're not alone if you're one of 'em!

The markets have changed.

Much of what people thought they knew about the financial markets and have been taught for a generation is outdated or simply no longer works the way it once did.

Diversification, for example, doesn't amount to much when everything goes down at once. The merits of "staying invested" like many brokers will tell you in volatile markets can't help if you don't have the staying power needed to do so.

Hedging can help.

Done correctly, hedging can:

...help you avoid risks that trip up most investors

...give you peace of mind

...ensure your profit potential remains intact

...help limit losses

...could even result in speculative profits

Hedging doesn't have to be complicated.

In fact, I believe anybody can learn to hedge quickly, easily, and effectively using a few simple investing tools and commonly available indicators that are included for free in most investment platforms.

Here's a quick taste of what you will learn:

- **Which** hedges work best
- **When** to use 'em
- **Why** you'll want to

The bottom line on hedging is super simple.

"Done right," hedging can help you maximize profit potential even as it helps you minimize risk practically no matter what the markets throw at you next.

Let's get started!

KF

IT'S NOT TOO LATE TO HEDGE

... Is it too late to hedge?

Not if you do it "right."

Let me explain.

As you might imagine, I'm getting asked that a lot lately. The selling is brutal.

Big-name analysts at firms like Goldman Sachs, Morgan Stanley, and Citi are warning that the Fed could hike rates faster and farther, that valuations are overdone, and that slowing economic growth is going to bring about an inglorious end to all things financial.

Investors are understandably nervous.

I get it.

The markets seem to be standing on the edge of a big, deep, nasty precipice. Many people want to protect everything they've worked so hard to save up and invest.

Hedging is a logical thing to be thinking about.

But, where to start?

The vast majority of brokers and financial advisors will blather on about diversification or the merits of staying invested in volatile times.

Others will talk about using fixed income – bonds by any other name – to protect against downside risk.

Both worked for years but ...

The markets have changed.

Much of what's taken for granted about the way markets work is no longer true. Especially as it relates to hedging.

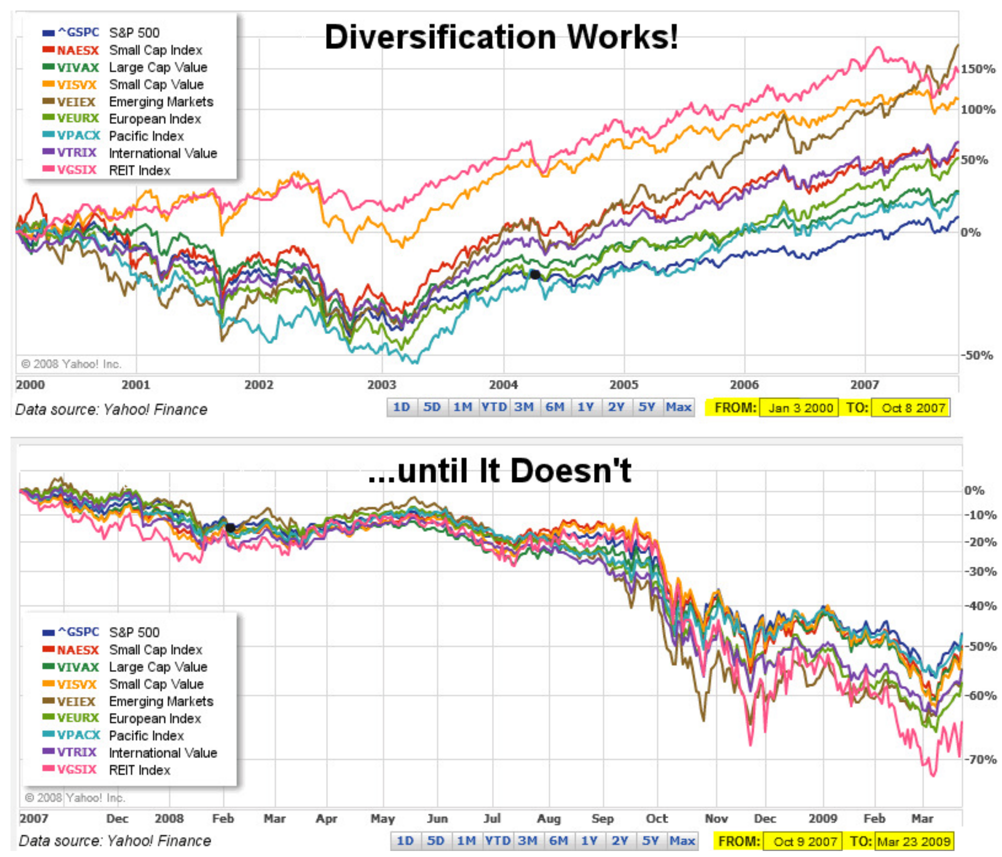
The premise behind diversification, for example, is that spreading your money around helps "because not everything goes down at once."

Diversification has been implicitly viewed as a "hedge" since the 1950s when economist Harry Markowitz figured out that the sum of a portfolio's parts could be less volatile than individual investments.

The problem is that today's financial markets actually do tend to move "all at once." And, a lot more often than people think.

This comes as a huge and often terribly rude awakening for legions of investors who have spent decades diversifying their investments like they've been told.

Today's markets are very different than they were back in the day. They're highly computerized, dynamic, and driven by leverage (so-called integrated funding channels) that have nothing to do with underlying fundamentals.



Source: Barry Ritholtz, 'The Big Picture'

Then there was the so-called "60/40" portfolio that came into vogue in the 1980s/1990s when "balanced funds" were the rage. For a long time that was viewed as an implicit "hedge" as well.

The problem with this line of thinking is that investment-grade bonds now yield substantially less than the rate of inflation which means anybody buying them is subjecting their money to a losing rate of return.

Bond yields have less room to drop during periods of market stress. Worse, bond prices can fall dramatically during periods of high inflation and sell off harder than the stocks they're supposed to balance.

IT’S NOT TOO LATE TO HEDGE

Fortunately, there is a simple and elegant solution ... *hedging*.

The first thing to understand is that the most successful hedges are put in place long before the herd realizes that anything is wrong.

Hedges, in that sense, are a lot like the seatbelt in your car. Ideally, you want to buckle in before you turn the key (what we do here at One Bar Ahead™) Not after you’ve had an accident (which is what most other investors do if they hedge at all).

That’s why, for example, we started talking about hedging using SH/RYURX late last year when nearly everybody else thought the bull market could run forever. Both have enjoyed a nice run higher as the S&P 500 has dropped off.

The second thing to understand about hedging is that most people don’t think about hedging until it’s too late.

There are a variety of reasons why this is the case but essentially it comes down to behavioural psychology. Social scientists call this avoidance behaviour – meaning people learn to fear situations that have caused them pain or stress in the past.

More often than not, that’s an *opening*.

The fabulous Jim Rogers drummed it into my head over the years that it’s the perfect time to look at the opposite of a trade – any trade – when “everybody knows something to be true.”

Excessively bullish headlines, for instance, are a sign that we want to be thinking about the market’s next downside move. Conversely, abjectly bearish headlines are a sign that we want to be thinking about prices taking off higher.

Mr. Rogers, in case you’re not familiar with him, partnered with George Soros to run the Quantum fund which generated a jaw-dropping 4,200% return from 1973 to 1980.

Hedging is not as tough as you’d think.

Here’s how.

Hedging “apples to apples” is important

Match your hedge to your holdings

People don’t talk about this a lot when the subject of hedging comes up, but they should. Ideally, you want to hedge apples with apples.

The One Bar Ahead™ Model Portfolio contains a lot of tech-related recommendations but my research shows that the underlying performance is far more likely to mirror the S&P 500 over time. That’s why I generally suggest the ProShares Short S&P 500 ETF (SH) or the Rydex Inverse S&P 500 Strategy Fund (RYURX) when it comes to hedging.

If you’re primarily concerned about tech stocks getting hammered for whatever reason - and I get that you might be - a choice like the ProShares PSQ ETF (PSQ) or the inverse ARK fund (SARK) could be appropriate.

Leveraged hedges like the ProShares Ultra VIX Short-Term Futures ETF (UVXY) or Direxion Daily S&P 500 Bull 3X Shares (SPXL) are best reserved for short-term speculative hedging ahead dramatic short-term moves and held for 24-48 hours at most.

The first 7-10% always belongs to the market

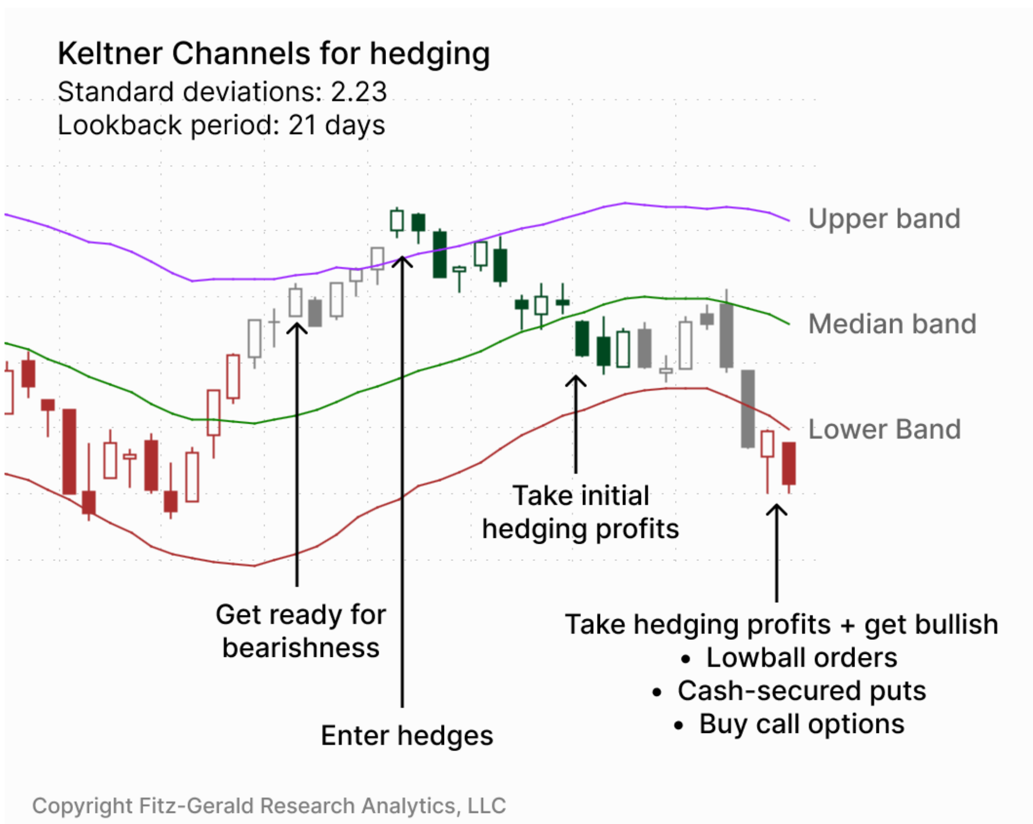
This is where trailing stops come into play and why you want to understand “normal” market behaviour, something we talk about a lot.

IT'S NOT TOO LATE TO HEDGE

As long as prices are within this range, there's no need to hedge beyond the 2-3% I recommend in SH or RYURX (unless you want to) because the risks of getting bounced out prematurely are greater than the opportunities associated with staying in.

I use the Master Market Indicator™ (MMI™) to help me gauge price action but you can just as easily use Keltner Bands set to 2.23 standard deviations and a lookback of 21 days.

Most brokerages' charting platforms or online alternatives have Keltner Bands built in and available for free.



When prices are tracking along the upper band, you'll want to consider adding to inverse ETFs like SH or an inverse fund like RYURX the moment they pull back or lower. If prices drop through the median to the lower band, that's when you can consider adding more to SH or RYURX more aggressively.

Exit or lighten up your hedge when prices cross above the lower band again.

If you're options savvy, consider buying puts 10-12% below current prices.

Remember, the most effective hedges are put in place when the overwhelming majority of people aren't thinking anything is wrong.

Doing this when prices are tracking the upper Keltner Band can be particularly cost-effective. That's because put options - that are a bet on lower prices – will be dirt cheap at that point.

Keltner Bands, in contrast to the more familiar Bollinger Bands, represent volatility around trend which means they will expand as volatility increases and narrow as it decreases.

As I type, for example, the difference is about 10-12% from the median value between the bands. Late last year it was just 6%, for example.

Don't wait for hell to freeze over before taking profits

Many people put their hedges on thinking that they'll hold 'em forever but that's asking for trouble. The real key to hedging effectively is taking profits as quickly as you can.

I suggest you consider taking profits when prices have moved about ½ the distance between the median bands. Or when the trend (as displayed by the Keltner Bands) has reversed direction.

There's nothing wrong with using the profits to buy more hedges if you're really freaking out. Besides, nobody ever went broke taking profits so there is that.

Get bullish

Many people think about hedges solely in terms of downside risk. What they fail to realize (or simply lose track of) is that when prices drop far enough that there are profits on your downside hedge, that's a good time to get bullish.

Start with stocks having the lowest MMI™ as reflected in the most recent One Bar Ahead™ issue or simply with those stocks that you'd like to own more of.

Using LowBall Orders or Selling Cash Secured Puts can also be an ideal way to do this. I've outlined the latter in the February 2021 issue which is available in the OBA Archives.

IT'S NOT TOO LATE TO HEDGE

Buying call options with strikes at or near the Keltner Band's Median Line (the middle one) could also be a quick source of profits using the same rules I've just outlined, just in reverse.

In closing, let me leave you with a final thought.

Volatility works in both directions which means hedging does too.

People forget that.

Try putting Keltner Bands on the screen and see if you can "tune in" to what they're telling you. The markets really will talk to you if you listen.

As always, try paper trading your hedges first.

Doing so helps keep risk to razor-thin levels while also allowing you to accumulate the intellectual reflexes needed to harness the chaos everybody else fears.

Who knows ... you might even have some fun!

KF

Got questions about the tactics mentioned in this guide? I love answering those.

Make sure you send your questions to **subscribers@keithfitz-gerald.com.**

I read every email I get, and would love to hear from you.

Want more? Consider signing up for One Bar Ahead™

What is it?

A monthly Digital Investing Journal that's filled with the latest tactics, news to pay attention to, and research recommendations written by Keith himself. It also includes a model portfolio, weekly updates, and weekly Ask-me-anythings.

What's included:

- Monthly Journal (~40 pages)
- Weekly portfolio updates
- Weekly AMA's (Ask-me-anything)
- Quarterly virtual "chalk talks"
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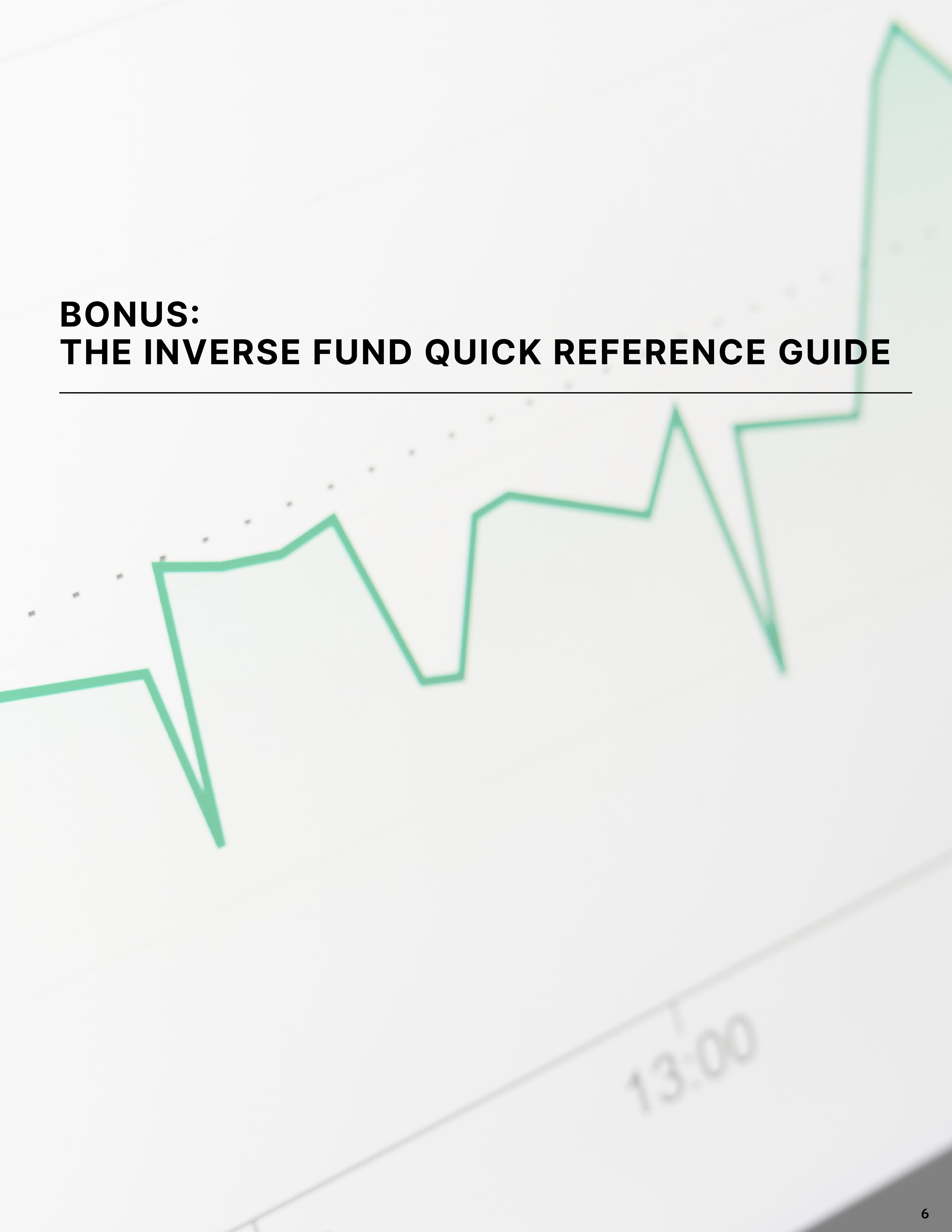


BONUS:
THE INVERSE FUND QUICK REFERENCE GUIDE

INVERSE FUND QUICK REFERENCE GUIDE

Hedging your investments has never been more critical

Or easier.

Here's a quick reference guide to my favourite inverse funds.

In case you're just joining us, inverse funds are a special class of investment that performs inversely – meaning opposite – of the indices they track.

For example, the ProShares Short S&P 500 (SH) is intended to appreciate as the S&P 500 to which it's benchmarked declines. Conversely, SH will lose money if the S&P 500 rises.

I'm a fan for three reasons.

First, inverse funds can help investors protect against unexpected market events in both directions when used properly as part of a comprehensive investment program.

Second, inverse funds are one of the very few tools available to individual investors today that can help tame Wall Street's shenanigans without the hassle or complexity of options.

And third, inverse funds can help dampen overall portfolio volatility which, in turn, means that savvy investors can stay "in to win" rather than being forced to sell stocks they'd otherwise rather continue to hold.

As I noted recently on May 6th, the SEC is considering a crackdown that is flawed and misguided IMHO, but I'll leave that for another time.

Meanwhile, here's what you need to know:

Protecting Against a Market Decline

This is where most investors start, usually because they want to protect an existing portfolio against market declines or even put a little extra speculative money to work to profit from a downside move.

The most effective hedges are 1:1, meaning they move dollar for dollar in the opposite direction to the underlying benchmark.

Studies show that having 2-5% of overall investment funds available in non-correlated or inversely-correlated choices can help dampen overall portfolio volatility.

The drawback, of course, is that inverse funds can drag on performance when things are good. I submit, like the seatbelt in your car, that's a win if they're not needed.

I do NOT advocate leveraged ETFs or leveraged inverse ETFs for ongoing hedging purposes because they are riskier than the non-leveraged 1:1 variety I've included in the following table and best reserved for short-term use only.

Remember, the goal when you are hedging is to mitigate risk, not create it.

1:1 Hedges Table

Fund Name	Ticker	Type	Daily Objective	Benchmark	YTD Return	$ Price
ProShares Short S&P500	SH	Equity	1:1	S&P500 (SPX)	18.91%	$16.10
ProShares Short QQQ	PSQ	Equity	1:1	Nasdaq 100 (NDX)	33.58%	$14.32
ProShares Short Dow30	DOG	Equity	1:1	Dow Jones Industrial Avg (INDU)	12.85%	$35.49
ProShares Short 7-10yr Treasury	TBX	Fixed Income	1:1	ICE US 7-10yr Bond Index (IDC0T74)	8.08%	$26.48

Data as of May 24th, 2022

INVERSE FUND QUICK REFERENCE GUIDE

Capitalizing on a Rising Market

Usually, there's enough upside in the markets themselves when stocks are heading higher, so taking on a leveraged ETF to harness a rising market doesn't make sense at first glance. But, as is often the case, looking deeper can present its own opportunities.

Leveraged upside investments give nimble investors the flexibility of additional profit potential if they're willing to be a) agile and b) have the liquidity needed to trade speculatively through rapidly changing markets on a daily basis.

Again, I do NOT advocate leveraged funds for ongoing hedging or investment purposes. They are intended for short-term use only because how they are constructed does not track the underlying indices to which they are benchmarked for anything longer than a day. Holding longer can actually work against you.

Harnessing Volatility

The following ETFs are a super-specialized way to play volatility itself.

Most investors diversify by type of investment – i.e. stocks, bonds, large-cap, sector and so on – but very few consider volatility itself as a tradable opportunity. And, in doing so, miss out.

Contrary to what many investors think though, UVXY and SVXY do not track the VIX and can, in fact, perform very differently than the VIX itself.

Both UVXY and SVXY provide leveraged exposure to the S&P 500 VIX Short-Term Futures Index, which measures the returns of a portfolio of monthly VIX futures contracts with a weighted average of one month to expiration.

The objective of using 'em is to reduce overall portfolio risk using changes in the VIX Short-Term Volatility Index which has historically been correlated with S&P 500 returns.

Like the leveraged inverse funds I've just mentioned, UVXY and SVXY are only intended for short-term daily use.

If you are uncomfortable with daily investment management and/or lack the skill set needed to make short-term directional bets involving volatility, do not use either!

Check with a financial professional if needed.

Leveraged Funds Table

Fund Name	Ticker	Type	Daily Objective	Benchmark	YTD Return	$ Price
Direxion Daily S&P500 Bull	SPXL	Equity	3:1	S&P500 (SPX)	-48.49%	$72.03
ProShares UltraPro QQQ	TQQQ	Equity	3:1	Nasdaq 100 (NDX)	-69.53%	$26.10
ProShares UltraPro Dow30	UDOW	Equity	3:1	Dow Jones Industrial Avg (INDU)	-37.72%	$53.75
ProShares Ultra VIX Short-Term Futures	UVXY	Volatility/ Futures	1.5x	VIX Futures	38.86%	$16.33
ProShares Short VIX Short-Term Futures	SVXY	Volatility/ Futures	1.5x	VIX Futures	-24.24%	$47.40

= Leveraged Bullish Funds

= Leveraged VIX Futures Funds

Data as of May 24th, 2022

INVERSE FUND QUICK REFERENCE GUIDE

Frequently Asked Questions

Q - How much should I hedge?

There's no wrong answer. Every investor's needs, risk tolerance and objectives are different.

Studies suggest maintaining 2-5% of total investable assets in non-correlated holdings can substantially reduce overall portfolio volatility.

Contrary to what many think, hedging is not an "on-off" switch, meaning you don't suddenly have it or get rid of it.

Done correctly, hedging is more like the ocean tide in that the need to hedge ebbs and flows over time.

A quick rule of thumb beyond the 2-5% is to add hedges for every additional ___% the markets fall. A figure you will ideally determine in advance so there is no ambiguity when the time comes.

Check with your financial professional to be sure.

Q - When do you "lift" your hedges, meaning remove them?

The same thinking applies.

The markets are not a light switch so it doesn't make sense to think "on/off" for most individual investors. Instead, think "more or less."

Consider adding hedges as price drops through the Keltner Bands I shared with you earlier. Or lightening up as price rises.

Alternatively, I've known traders who use a simple setup with 3 moving averages - a fast, medium and slow.

In that case, consider using the "fast" line as your signal whenever it crosses above or below the slower lines.

Q - What if I want to use more sophisticated hedges?

Hedging is a lot like cooking. The "recipes" can be as simple or as complex as you want.

I am a huge fan of keeping things stupid simple.

Ongoing hedging can be accomplished effectively with the 1:1 funds I've outlined (or similar alternatives).

Opportunistic hedging can be accomplished with the leveraged funds (or similar alternatives) I've outlined, but only for short periods of time ie. a day or two at most.

If you do want to take things up a notch and have the skills to do that, "beta weighting" may be appealing.

Beta-weighting gives you the ability to assess all your investments relative to a move in the S&P 500 (or another specific asset).

The "score" can help you understand how your portfolio will react to changes in volatility as well as the size, comparative diversity and more of your individual investments.

There's also "convexity-based" hedging.

Convexity refers to how an investment deviates from its benchmark under specific market conditions.

Upside convexity means an investment or a portfolio rises faster than its benchmark while downside convexity refers to an investment or portfolio not falling as fast nor as far.

Downside convexity is typically used to protect capital against deep drawdowns. It can be used strategically or tactically.

Upside convexity is often used to hedge risk and harness a big upside move while not committing excess capital to risky assets or using leverage.

Both Beta Weighting and Convexity are beyond the scope of today's report but included in One Bar Ahead™ on an ongoing basis.

Special Considerations

- Inverse funds allow you to play both sides of the market – up and down – without the hassle or complexity of options.
- Inverse funds are a directional play and, as such, they are not suitable for all investors, so think carefully about using them if you're uncomfortable doing so. Check with a financial adviser to be sure.
- Leveraged ETFs and leveraged inverse ETFs are riskier than those that do not use leverage. They are suitable only for investors comfortable with actively managing their investments on a daily basis.

Where to learn more

Keith Fitz-Gerald is a private investor, analyst, and market researcher/educator based in the United States, active in the financial markets for the past 40 years.

He's logged more than 2,000+ prime time appearances on the Fox Business Network, CNBC, Yahoo! Finance, Bloomberg and other networks since beginning his career at Wilshire Associates in the 1980s.

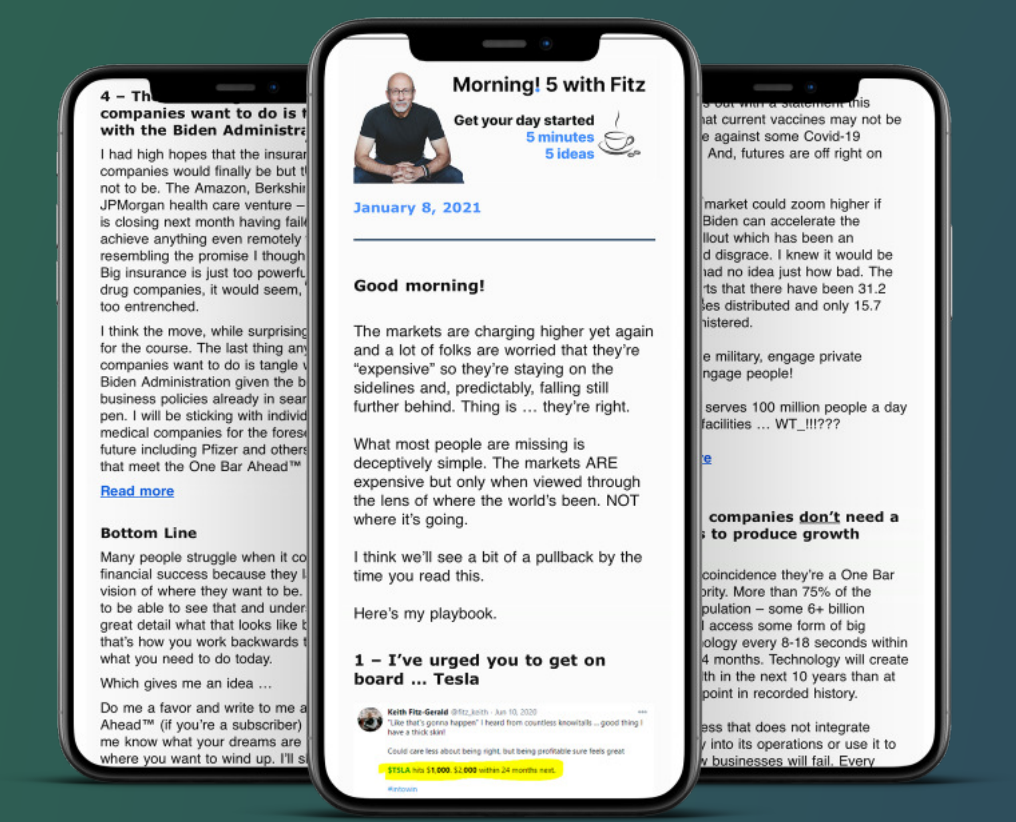
Keith's commentary, observations and analysis have been featured in such notable publications as the Wall Street Journal, The Times, Wired, Barron's and Forbes.com which labelled him a market visionary.

He has been a frequent speaker for the past 18 years and a popular educator who believes that anyone can be fabulously successful in the markets when armed with the right education, research, and tactics.

→www.keithfitz-gerald.com/about

Thank You for Reading Your 5-Minute Guide to Hedging

The quest for consistent safety-first, big picture profits never stops. You simply need access to the right stocks, the right strategies and the right education. No gotchas, no gimmicks. In plain English.



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