# Three portfolio strategies to hedge political risk

By John Wasik

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(Reuters) - For angst-addled market watchers, the U.S. debt ceiling and budget chaos has been like one of those amusement-park rides in which you ride upside down. It's harrowing and probably not over yet.

In addition to market and credit risk in the stock and bond markets, you need to be acutely aware of political risk. That means finding pockets of profit that are not dependent upon Washington.

Here are three strategies:

1. Balance risk in one fund

If you're a fairly moderate to conservative investor, having a balanced fund as a core holding could replace several funds that hold just stocks or bonds. While you're not entirely insulated from political risk, it's more of a hedge than being completely exposed to stocks or bonds. But can you get one mutual fund to do this for you in a tactical way?

The Oakmark Equity and Income Fund is an actively managed fund that shifts between stocks, bonds and cash. But the Oakmark fund is not your typical 60-percent stocks, 40-percent bond mix. The fund can invest up to 35 percent of its assets in non-U.S. securities, which it has done with stakes in Nestle S.A. ADR and Diageo PLC ADR.

Unlike most balanced funds, it has nearly three-quarters of its assets in stocks, with about a quarter in bonds and cash. It's done well to date; it's up 18 percent for the year through October 18, compared with 12 percent for a Morningstar moderate-risk index. The fund charges 0.78 percent annually for expenses.

If you want a more traditional, fixed approach and passive style, then consider the Vanguard Balanced Index Fund, which is up about 14 percent for the year through October 18 and charges 0.24 percent annually.

2. Buy emerging-markets bonds

If owning U.S. Treasuries makes you skittish after the debt-ceiling stand-off, then diversifying into emerging-markets bonds might provide a good idea.

Emerging markets bonds, which tend to be much more volatile than the balanced approach, should be considered "satellite" holdings for the income portion of your portfolio. Dividend-payers, in contrast, can be held long-term and be part of a growth-and-income strategy.

Although bonds from developing countries have been taking it on the chin this year, they are poised for a rebound if the Federal Reserve continues its easing policy. A worthy choice is the iShares JP Morgan US Dollar Emerging Markets Bond ETF, which charges 0.60 percent for annual management.

The fund, which holds bonds from [Brazil](http://www.reuters.com/places/brazil), the Russian Federation, Turkey and other developing countries, is down 5 percent for the year, but up 13 percent over the past five. It yields nearly 5 percent.

Keep in mind that emerging-markets bonds, which tend to be much more volatile than the balanced approach described above, should be considered "satellite" holdings for the income portion of your portfolio.

3. Hold U.S. dividend-paying stocks

For most investors, a steady dividend is cash in hand that has little or no connection to Washington's bipolar financing talks. In addition, dividend-payers can be held long-term and be part of a growth and income strategy.

According to S&P [Dow](http://www.reuters.com/finance/markets/index?symbol=us%21dji) Jones Indices, a few companies are poised to raise dividends because of strong profits and cash flows. This elite group includes AFLAC, Inc., AT&T, Inc., Emerson Electric and McCormick & Co..

If you don't have a portfolio that holds stocks like these through dividend-reinvestment plans, a good vehicle for holding a variety of them is through the SPDR S&P Dividend ETF, which charges 0.35 percent annually.

The fund gained about 23 percent for the year though October 18 as dividend payers continue to remain in favor among defensive investors. That return compares with 22 percent for the S&P 500 index over the same period, and the fund yields 2.5 percent.

Of course, not even experienced Washington pundits can predict what shape political risk will take in the future as both parties tussle over the budget and federal debt ceiling.

Only one thing is certain: government disruptions and budget slashing will deprive the U.S. economy of even more growth, which could push the nation closer to another recession. If that happens, you can hedge political risk all you want, but it won't alleviate the damage to the stock, housing and labor markets.

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Editing by Lauren Young and Dan Grebler)

# A Beginner's Guide To Hedging

By [Investopedia Staff](http://www.investopedia.com/contributors/79) on February 19, 2010  A A A

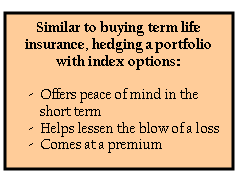
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Although it sounds like your neighbor's hobby who's obsessed with his topiary garden full of tall bushes shaped like giraffes and dinosaurs, [hedging](http://www.investopedia.com/terms/h/hedge.asp) is a practice every investor should know about. There is no arguing that portfolio protection is often just as important as portfolio appreciation. Like your neighbor's obsession, however, hedging is talked about more than it is explained, making it seem as though it belongs only to the most esoteric financial realms. Well, even if you are a beginner, you can learn what hedging is, how it works and what hedging techniques investors and companies use to protect themselves.  
  
**What Is Hedging?**The best way to understand hedging is to think of it as insurance. When people decide to hedge, they are insuring themselves against a negative event. This doesn't prevent a negative event from happening, but if it does happen and you're properly hedged, the impact of the event is reduced. So, hedging occurs almost everywhere, and we see it everyday. For example, if you buy house insurance, you are hedging yourself against fires, break-ins or other unforeseen disasters.   
  
Portfolio managers, individual investors and corporations use hedging techniques to reduce their exposure to various risks. In financial markets, however, hedging becomes more complicated than simply paying an insurance company a fee every year. Hedging against investment risk means strategically using instruments in the market to offset the risk of any adverse price movements. In other words, investors hedge one investment by making another.  
  
Technically, to hedge you would invest in two securities with negative [correlations](http://www.investopedia.com/terms/c/correlation.asp). Of course, nothing in this world is free, so you still have to pay for this type of insurance in one form or another.   
  
Although some of us may fantasize about a world where profit potentials are limitless but also risk free, hedging can't help us escape the hard reality of the [risk-return tradeoff](http://www.investopedia.com/terms/r/riskreturntradeoff.asp). A reduction in risk will always mean a reduction in potential profits. So, hedging, for the most part, is a technique not by which you will make money but by which you can reduce potential loss. If the investment you are hedging against makes money, you will have typically reduced the profit that you could have made, and if the investment loses money, your hedge, if successful, will reduce that loss.   
 **How Do Investors Hedge?**   
Hedging techniques generally involve the use of complicated financial instruments known as [derivatives](http://www.investopedia.com/terms/d/derivative.asp), the two most common of which are [options](http://www.investopedia.com/terms/o/option.asp) and [futures](http://www.investopedia.com/terms/f/futures.asp). We're not going to get into the nitty-gritty of describing how these instruments work, but for now just keep in mind that with these instruments you can develop trading strategies where a loss in one investment is offset by a gain in a derivative.  
  
Let's see how this works with an example. Say you own shares of Cory's Tequila Corporation (Ticker: CTC). Although you believe in this company for the long run, you are a little worried about some short-term losses in the tequila industry. To protect yourself from a fall in CTC you can buy a [put option](http://www.investopedia.com/terms/p/put.asp) (a derivative) on the company, which gives you the right to sell CTC at a specific price ([strike price](http://www.investopedia.com/terms/s/strikeprice.asp)). This strategy is known as a [married put](http://www.investopedia.com/terms/m/marriedput.asp). If your stock price tumbles below the strike price, these losses will be offset by gains in the put option. (For more information, see this [article on married puts](http://www.investopedia.com/articles/optioninvestor/080101.asp) or this [options basics tutorial](http://www.investopedia.com/university/options/).)

The other classic hedging example involves a company that depends on a certain commodity. Let's say Cory's Tequila Corporation is worried about the [volatility](http://www.investopedia.com/terms/v/volatility.asp) in the price of agave, the plant used to make tequila. The company would be in deep trouble if the price of agave were to skyrocket, which would severelyeat into profit margins. To protect (hedge) against the uncertainty of agave prices, CTC can enter into a futures contract (or its less regulated cousin, the forward contract), which allows the company to buy the agave at a specific price at a set date in the future. Now CTC can budget without worrying about the fluctuating commodity.  
  
If the agave skyrockets above that price specified by the futures contract, the hedge will have paid off because CTC will save money by paying the lower price. However, if the price goes down, CTC is still obligated to pay the price in the contract and actually would have been better off not hedging.  
  
Keep in mind that because there are so many different types of options and futures contracts an investor can hedge against nearly anything, whether a stock, commodity price, interest rate and currency - investors can even hedge against the weather.  
  
**The Downside**   
Every hedge has a cost, so before you decide to use hedging, you must ask yourself if the benefits received from it justify the expense. Remember, the goal of hedging isn't to make money but to protect from losses. The cost of the hedge - whether it is the cost of an option or lost profits from being on the wrong side of a futures contract - cannot be avoided. This is the price you have to pay to avoid uncertainty.  
  
We've been comparing hedging versus insurance, but we should emphasize that insurance is far more precise than hedging. With insurance, you are completely compensated for your loss (usually minus a deductible). Hedging a portfolio isn't a perfect science and things can go wrong. Although risk managers are always aiming for the perfect hedge, it is difficult to achieve in practice.  
  
**What Hedging Means to You**   
The majority of investors will never trade a derivative contract in their life. In fact most [buy-and-hold](http://www.investopedia.com/terms/b/buyandhold.asp) investors ignore short-term fluctuation altogether. For these investors there is little point in engaging in hedging because they let their investments grow with the overall market. So why learn about hedging?   
  
Even if you never hedge for your own portfolio you should understand how it works because many big companies and investment funds will hedge in some form. Oil companies, for example, might hedge against the price of oil while an international mutual fund might hedge against fluctuations in foreign exchange rates. An understanding of hedging will help you to comprehend and analyze these investments.   
  
**Conclusion**Risk is an essential yet precarious element of investing. Regardless of what kind of investor one aims to be, having a basic knowledge of hedging strategies will lead to better awareness of how investors and companies work to protect themselves. Whether or not you decide to start practicing the intricate uses of derivatives, learning about how hedging works will help advance your understanding of the market, which will always help you be a better investor.

**Hedging a Portfolio with Index Puts**  
Andrea Kramer (akramer@sir-inc.com)

As you probably already know, options aren't just for speculating. Options traders can also hedge individual trades or even entire portfolios. This article discusses how traders can **hedge their portfolios with index puts**.

**Who should tune in?** Typically, traders will utilize index puts as a hedge when they are concerned about a potential drop in the value of their portfolio. If the market moves against their stock positions, the hedge will help lessen the hit, acting as a form of term life insurance against downward moves. In other words, investors seeking peace of mind – and who are willing to pay for it – should consider utilizing index options.

**How does it work?** Index puts generally increase in value as the market declines, counteracting the loss in a stock portfolio. By purchasing index puts, the trader can still participate in the upside of the market through their long stock positions, while insuring against pullbacks.

Simply put, if an investor’s portfolio declines in value, an index that corresponds to the movement of that portfolio will drop in parity. By purchasing a put on that index, the trader is entitled, at expiration, to an amount of cash proportionate to the drop of the index below the strike price.

**What’s in it for me?** Again, the primary motivation for hedging with index puts – like buying term life insurance – is peace of mind. When a person dies, their loved ones are usually overcome with grief. However, knowing that an insurance policy was in place generally helps to ease – not erase – some of the pain. On that same note, having an index put in place helps dull the ache felt when a portfolio succumbs to the downside.

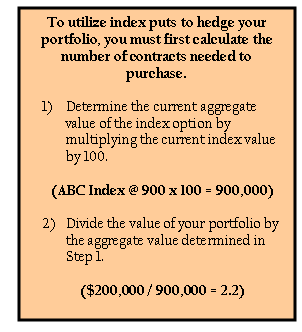
**What do I have to lose?** As most of us already know, insurance doesn’t come free, and the premium paid for an index put is similar to a premium paid for any form of insurance. And, while there are several tiers of insurance premiums, the range of cost for hedging with index puts varies, too.

Buying an in-the-money option with a high delta incurs a higher premium cost, but usually covers almost all of the trader’s exposure. On the flip side, purchasing an out-of-the-money option with a low delta is cheaper, but only covers significant moves against the portfolio.

If the market correction didn’t occur by the index option’s expiration, the puts could expire worthless and the trader would forfeit the premium paid. However, the investor has options if the index doesn’t decline by expiration, like extending their portfolio insurance by buying another option with a later expiration, or rolling out.

*In addition, don’t forget to include any brokerage fees when calculating the total cost of this hedging strategy.*

**Let’s look at an example.**

Meet Ricky, who has $200,000 invested in a portfolio containing some of the large-cap names in the ABC Index, which is currently trading around 900. Ricky is long-term bullish on his portfolio components, but is concerned about a broad-based pullback to the 850 level – a 5.5% decline – within the next couple of months. 

With this in mind, Ricky wants to purchase enough put protection utilizing ABC Index options to cover his portfolio. Because each option contract represents 100 shares, he must buy 2.2 put contracts ($200,000/ [900 x 100] = 2.2). However, since you can’t purchase a portion of an option contract, he’ll need to buy either more (three contracts) or less (two contract) “insurance” to hedge his bets. Taking the more conservative route, Ricky opts to buy two ABC Index puts.

Considering his expectations, he opts to buy two at-the-money September 900 puts at $15 for a total of $3,000 (15 x 2 x 100), or only 1.5% of his portfolio investment. This hedge gives Ricky the right to collect the amount by which the ABC Index declines below the 900 strike through September expiration. However, if the index fails to decline before options expiration, the *most* Ricky could lose is his original investment – plus, he still gets to collect on the gains in his portfolio.

Now, let’s say that in the next couple of months, Ricky’s portfolio declines in value by about 10%, or $20,000, to $180,000. Since the ABC Index runs in virtual parity, let’s assume that it has also dropped by about 10%, or 90 points, to the 810 level. Ricky’s 900-strike puts are now in the money by 90 points, boasting an intrinsic value of $18,000 (90 x 2 x 100).

His first option would be to hold the options through expiration and collect the proceeds, which would help to offset his portfolio losses from $20,000 to $5,000 ($20,000 – [$18,000 – premium paid of $3,000]). However, if Ricky feels the broad-market decline is far from over, he could use his proceeds from the puts to roll out to a longer-date option series and protect against further declines.

On the other hand, Ricky could sell the purchased puts before September expiration at a substantial premium to the amount the puts are in the money, depending on the amount of time value still remaining.

**Words of wisdom**

In conclusion, hedging a portfolio with index options is a way to hold on to certain stocks for the long haul while protecting against a decline in the short term. Plus, it’s more economical than temporarily selling and repurchasing individual stocks, and offers the trader peace of mind. Similar to buying term life insurance, this hedging strategy is short-lived and comes at a cost – but, though you may not need it in the long run, it’s a lot easier to sleep at night knowing you’re protected.

### Five Hedging Strategies for Stock Pickers

**Investors who feel the market is overvalued have two options: move into other asset classes (cash, bonds), or hedge their market exposure.  Hedging your exposure does not have to be rocket science, but it does require diligent attention to the market and your portfolio.**

I recently discussed how [it makes sense to be out of the market if you expect that there is a good chance of a large decline](http://www.altenergystocks.com/archives/2009/08/when_market_calls_are_wrong.html), even if that means there is as much of a chance of missing a large upswing as there is a large decline. In my estimation, this is one of those times.

Staying out of the market seldom makes sense for typical index investors, who know that they do not have the skills, time, or knowledge to beat the market.  Such investors probably also believe that they can't time the market, so their strategy is limited to adjusting their exposure to the market index based on their financial needs and risk tolerance, irrespective of market conditions.  For them, investing is an exercise in financial planning, not market timing.

The rest of us believe that we are the exceptions that prove the rule, despite the mountains of evidence that nearly all investors fail to beat the market.  If we're right that we do have an edge, staying out of the market for any prolonged period means that we're giving up *more* than just market returns; we're also giving up any excess return we expect to earn with our (most likely imaginary) skills. If we want to continue to capture that excess return, we need to remain in the market, but hedge our exposure to general market movements.

**Market Factors: What Should You Hedge Against?**

According to the [Arbitrage Pricing Theory](http://en.wikipedia.org/wiki/Arbitrage_pricing_theory) (APT), the expected return of a stock is a linear combination of a list of factors to which it is sensitive.  In its simplest form (the familiar [Capital Asset Pricing Model](http://en.wikipedia.org/wiki/Capital_Asset_Pricing_Model), or CAPM), there is only one factor, the overall market return, while more complicated versions include factors such as market capitalization, market sector, or value vs. growth.

We don't need to specify the market factors in our APT model in order to hedge effectively.  We can focus on the factor we are concerned will cause a decline.  Our first step is to choose an index or economic indicator for which we can get frequent price data that encapsulates the risks we feel are most important.

If we are concerned about a general market decline due to overvaluation, then a broad market index such as the [Russell 3000](http://en.wikipedia.org/wiki/Russell_3000_Index) will do.  If we are concerned about a market decline due to rising oil prices, we can use the oil price as the factor we hedge against.  If we're more concerned about declines in a market sector, we can use a sector index for that sector, such as an [energy sector index](http://finance.yahoo.com/q?s=%5EGSPE).

We should be careful that we're not hedging away the market factors from which we derive our advantage.  For instance, I invest in clean energy companies because I believe that long term rising energy prices and increased regulation of greenhouse gas emissions will benefit these companies.  But increasing energy prices are likely to benefit most companies in the energy sector, so I would be losing part of my advantage if I chose an energy sector index as the market factor to hedge against, so a broad market index is more appropriate than an energy sector index for my purposes.

In the discussion below, references to an "index" refer to the market factor we have chosen to hedge against.

**Hedging Instruments**

There are many type of market instruments which can be used to hedge a portfolio, five variations are listed below.

|  |  |  |
| --- | --- | --- |
| **Instrument** | **Advantages** | **Disadvantages** |
| [*Short & Ultrashort ETFs*](http://www.altenergystocks.com/archives/2009/02/ultrapromises_fall_short.html) | Can use in any brokerage account | Sacrifice of upside potential, and loses money over time in volatile markets. |
| *Sell Covered Calls on stocks in portfolio* | Makes money in flat markets | Sacrifice of upside potential; hedge against small declines only. |
| *Buy Puts on index or specific stocks* | No loss of upside; protects against large losses | Works like insurance; has up-front cost. |
| *Short the index* | Protects against full range of index declines | Sacrifice of upside potential; must pay dividends |
| *Sell naked calls on the index* | Makes money in flat markets | Sacrifice of upside potential; limited downside protection. |

I list *buying Short and Ultrashort ETFs* first because this is the option which is most easily available to all investors.  If you can buy stocks, you can buy Short or Ultrashort ETFs based on dozens of market indexes.  If the underlying index rises (falls) by 2% in a day, a corresponding Short ETF will fall (rises) by approximately 2%, and an Ultrashort ETF will fall (rise) by 4%.

Unfortunately, [Short and Ultrashort ETFs (along with related leveraged ETFs) have a fatal flaw which makes them unsuitable for long term use](http://www.altenergystocks.com/archives/2009/02/ultrapromises_fall_short.html).  When the underlying index is volatile, these instruments lose money over time due to the geometric nature of compounding.  To give an example, [SH](http://finance.yahoo.com/q?s=sh&.yficrumb=X1Nf%2FlYKD8e) is a short ETF designed to produce the inverse of the S&P500 daily return.  The S&P500 closed on August 4 at 1005.65.  On September 3, it closed at 1003.24, a decline of 0.25%.  Over the same period, SH lost 0.1%, compared to the 0.25% gain you might expect.  Annualized, that's the equivalent of losing about 4.5%.

To show that this is the result of the underlying structure of SH, and not poor execution on the part of the ETF manager, we can see the same effect in a simple example.  Suppose on Tuesday the S&P500 were to go from 1000 to 1100 (a 10% gain), and then fall back to 1000 on Wednesday (a 9.1% decline.)  SH would fall 10% on Tuesday, and gain 9.1% on Wednesday, for a net loss of 0.90 x 1.091-1= -0.018 = -1.8%.  I go into more detail in my article on [Ultra ETFs](http://www.altenergystocks.com/archives/2009/09/www.altenergystocks.com/archives/2009/02/ultrapromises_fall_short.html) from February, but the result is that these instruments are not suitable for hedging.

*Selling Covered Calls* on the stocks in your portfolio requires the most basic level of options permission from your broker.  Given the very low risk of this options strategy, however, you do not have to have extensive knowledge or experience with options to get permission to [sell (or "write") covered calls](http://www.option-trading-guide.com/coveredcalls.html).  You can follow the link for a detailed how-to; I'll stick to the advantages and disadvantages of covered calls as a hedging strategy.

There are two main advantages.  First, covered calls are tools which are reasonably available to most stock market investors with only the hour or so of work which is required to get low level options trading permission from your broker.  Previous options trading experience is unlikely to be necessary, and this is a good way to get options trading experience if your broker requires it in order to start using more sophisticated options strategies.

Second, you only need the market to *not go up* in order to be better off by selling covered calls.  Ideally, the market will be relatively stable, and you will not lose money on your stocks, but you will make gains on the calls you write.

The disadvantages of covered calls are that your downside protection is fairly limited, usually to declines of 5-10%, while you give up all the potential of upside gains in the underlying stock.  This is a strategy I use with stocks that I don't think have much potential for outsized gains. Selling covered calls is an incomplete hedging strategy offering no protection against large market declines, and so I use it only in conjunction with at least one of the other strategies listed below.

*Buying Puts* is very much like buying insurance on your portfolio.  If you want to protect against large declines in specific stocks, you can buy puts allowing you to sell those stocks for a fixed price at a later date.  If you want to protect against a large decline of an index, you can buy puts on that index (or index ETF) which will settle for cash if the index falls below the strike price, or you can buy the ETF at the future reduced price, and sell it at the strike price for a profit, offsetting losses elsewhere in your portfolio.

The main advantages of buying puts are that they offer complete protection against declines past the strike price of your choosing, and there is no loss of upside potential in your portfolio. Puts are one-sided bets.  Like most one-sided bets, they come at a cost.  The insurance puts offer requires paying a premium, and that premium must be renewed when they reach their expiration date.

Another advantage of buying puts is that it is only slightly harder to get options permission allowing you to buy puts than it is to get permission to sell covered calls.  The strategies which follow both can entail theoretically unlimited losses, and getting permission from your broker to use them is correspondingly more difficult.

*Shorting the Index*(or index ETF) is the classic way to hedge.  When the index goes up, you lose money on your short position, but your stock portfolio should be rising as well, insulating you from the market move.  When the index declines, the gains in your short position offset the expected losses elsewhere in your portfolio.

The main advantage of shorting the index is simplicity.  Unlike options strategies, you do not need to periodically renew your positions as options expire, or to adjust your exposure as the sensitivity of the options changes with market moves (more about this below).  The main disadvantages are that you will need to pay any dividends declared on the security you are shorting, and you generally do not earn interest on the cash retained in your margin account to cover the short position.  If the short moves against you, you may even have to come up with more cash to cover the short position, or begin paying margin interest.  This is in contrast to selling/writing calls, where you are able to earn interest (or even re-invest the cash received.)

*Selling (Writing) Calls on the Index* (or index ETF) is a hybrid between selling covered calls and shorting the index.  Unlike shorting, the balance which you need to maintain to cover the position will usually accrue interest, and you will also tend to make money on the premiums for which the calls were written if the index stays relatively flat.

This does have the disadvantage that there is little protection against declines in the index below the strike price of the call you sold.  However, you can sell calls with strike prices considerably below the current level of the index (although this comes at a cost of smaller gains when the index is flat.)  Another strategy is to continue selling more calls dynamically as the index declines, which works so long as the market does not decline so quickly that it is difficult to find call buyers at reasonable prices.

This has long been my primary hedging strategy, but I have recently shifted to a slightly more complex (if related) [hedging strategy of selling short call spreads](http://www.altenergystocks.com/archives/2009/09/blackswan.html).  I will publish a short article about this strategy later this week, when you can find it at the previous link (which will be broken until then.)

**How Much to Hedge**

You now should know which market factor you want to hedge against, and which hedging instruments you plan to use.  It's theoretically possible to calculate the precise number of options or shares to use in your hedge in order to achieve a particular exposure.  The calculation depends on the variances and covariances of the various instruments and securities in your portfolio with the index and each other.  These statistics not only require considerable market data and number crunching to calculate, but they are prone to change over time and in different market conditions, making such calculations extremely complex and even unreliable in practice.

Fortunately, there is a much simpler way to determine and refine the effectiveness of your hedge.  The only data you need is daily price date for the index you have chosen to hedge against, and the daily total value of your account.  The daily historical values of your account are not usually available from most brokers, so this requires logging in each evening and recording the account value.  Fortunately, the method still works if you miss a day here or there.

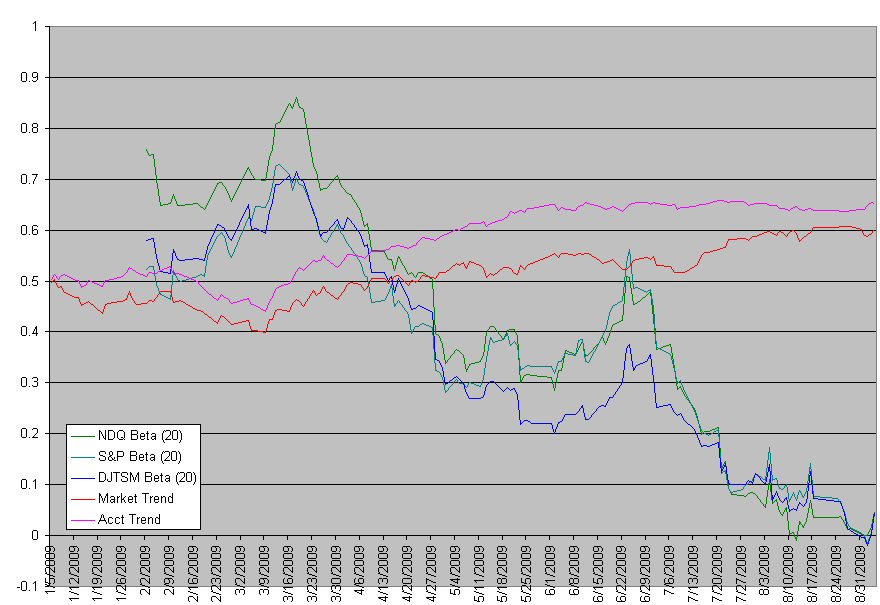
Set up a spreadsheet with columns as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Date** | **Index** | **Acct** | **Index Change** | **Account Change** | **Beta** |
| A1 | B1 | C1 |  |  |  |
| A2 | B2 | C2 | D2=B2/B1-1 | E2=C2/C1-1 |  |
| ... | ... | ... | ... | ... |  |
| A3 | B20 | C20 | D20=B20/B19-1 | E20=C20/C19-1 | =CORREL(D1:D20,E1:E20)\*  STDEVA(E1:E20)/  STDEVA(D1:D20) |
| A4 | B21 | C21 | D21=B21/B20-1 | E21=C21/C20-1 | =CORREL(D2:D21,E2:E21)\*  STDEVA(E2:E21)/  STDEVA(D2:D21) |

Once you have the first 20 rows filled in, you can just copy the final 3 columns from a previous row in order to continue the sequence.  Note that corrections will need to be made in the "Account Change" column if you take money out of or put money into your account.

The formula in the "Beta" column uses Microsoft Excel functions to calculate the Beta for your account relative to the index over the last 20 trading days (approximately 1 month).  In other words, for every 1% change in the index over the last 20 trading days, your account changed Beta percent.   A perfectly hedged account will have a Beta of 0.

Below is a graph of Beta for my largest account for this year against three indexes: The S&P500, the Nasdaq, and the Dow Jones Total Stock Market index.  The magenta line shows the trend for the account itself, while the red line is a composite of those three indexes (click on the chart for a higher resolution view.)

[](http://www.altenergystocks.com/archives/betachart.bmp)

As you can see, I started the year with a Beta of around 0.6. At that time, I was participating in 60% of the gains and losses from general market trends.  I maintained a moderately positive Beta at the start of the year because I was cautiously bullish on the market as a whole.  In April, I began to feel that the market was advancing too far, too fast and I began to increase my hedge by selling calls on market index ETFs.  By early June, I had become increasingly bearish, and published my market call saying ["we're near the peak."](http://www.altenergystocks.com/archives/2009/06/market_call_were_near_the_peak.html)  Since then, I have continued to hedge, and now the account has a Beta near zero, meaning that changes in the account value will have more to do with my particular stock picks than with general market moves.

By monitoring your own spreadsheet, you can have a good idea how effective your hedge is operating.  If you expect the market to decline, you should keep your own account's Beta at zero, or even negative.  If you're aggressively bullish, you'll want a Beta near 1 or higher.  You can raise your account's Beta by decreasing the size of your hedge or adding to your stock portfolio, and you can decrease your account's hedge by selling stocks or adding to your hedge.  This is what I meant earlier when I referred to "selling more calls dynamically."

**A Watchful Eye**

The key to hedging is regular monitoring, preferably daily.  The increase in my account's Beta in June was not due to me decreasing my hedge, but to changes in the internal correlations of the market.  You account's Beta will tend to drift over time due to such changes, and effective hedging requires that you make occasional trades to keep it near the desired level.

For most investors, the daily monitoring required to keep a portfolio properly hedged is probably too much work.  If that is the case for you, and you also feel that the market is likely to decline, the best strategy is probably to sell most of your stock portfolio and wait on the sidelines until the market declines to better valuations.  The use of simple hedging strategies such as shorting the index may compensate somewhat for less frequent monitoring, but changing market conditions mean that even this strategy is probably only appropriate for relatively active investors.

DISCLOSURE: None.  
  
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