

Module 1.1 – Introduction to Hedging

Welcome to the first video in Module 1 – How to Protect your Portfolio in a Falling Market. My name is Christina, and today I will be providing you with an introduction to hedging your portfolio using options.

Before we proceed, I highly recommend that you have an understanding of **put options** and suggest that you first do Module 0 on Options Basics, if you don't.

Inside this video, we will cover three main points:

1. What is hedging?
2. Why do we need to hedge?
3. When do we need to hedge?

By the end of this video, you will have an understanding of what hedging is, why we do it and when we need to hedge.

Without further ado, let's get straight into the first point:

1. What is hedging?

Hedging is any technique designed to reduce or eliminate financial risk; for example, taking two positions that will offset each other if prices change.

The best way to understand hedging is to think of it as insurance. When people decide to hedge, they are insuring themselves against an adverse 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.

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.

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.

The hedging method that we like to use for protecting stock portfolios is by using **Put Options**. Owning Put Options ensure that we can sell our stock at a pre-determined price no matter what happens.

We will show you how to use Put Options to hedge in the next two videos in this module.

2. Why do we need to hedge?

The main reason for hedging is to reduce risk.

Some of the major risks for stock investments are:

1. Market risk – that is, risks that could cause the whole stock market falls such as a global credit crunch
2. Sector risk – that is, risk that cause all the stocks in a particular sector to fall such as an increase in oil prices could cause all transportation stocks to fall
3. Company specific risk- that is, risk that is specific to a particular stock such as poor earnings or profit forecast.

Professional portfolio managers use hedging techniques to reduce their exposure to these various risks, however, most stock portfolios of retail investors are unhedged. You profit when your stocks goes up but lose money when your stocks go down.

Hedging is generally not needed in a bull market. The prices of stocks tend to go up, pause or pull back a little and then continue up again.

However after 2008, all stock investors are aware that stocks prices don't always go up so it may be a good idea to hedge to reduce losses when stock prices fall.

3. When do we need to hedge?

We should hedge whenever we sense imminent risk events. It is not always possible to identify risk events like natural disasters or terrorist attacks.

However, there are risk events that are predictable such as:

- **Loss of capital in new stock positions.** Your biggest risk occurs when you open a new stock position. If the stock price moves against you, you will lose actual capital, not just paper gains. Warren Buffet's golden rules are
 - "Rule No.1: Never lose money.
 - Rule No.2: Never forget rule No.1".
- **Earnings announcements.** If you own a volatile stock that tends to have big price moves based on earnings, it would be a good idea to buy a Put Option before each earnings announcement.
- **Bearish chart patterns.** If you own a stock and prices have broken a long-term uptrend line, you may want to buy a Put Option to lock in your unrealised gains and/or limit your loss in case the stock continues to fall.

You may also want to hedge you entire stock portfolio when you observe bearish chart patterns on major stock indexes such as the ASX 200 index.

In Closing

All investments have risk

Your ability to manage the risk will help you be a better investor.

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 cannot be avoided. This is the price you have to pay to avoid uncertainty.

That brings us to the end of this video. I hope that you've found it useful and that you have an understanding of hedging and how you can reduce loss on your stock portfolio when prices fall.

I recommend that you watch all the videos in this module first just to make sure that you have an overview of everything before you apply it to your portfolio.

Take your time and watch any of the videos as many times as you need to ensure that you understand the concepts we have been looking at.

There are also a number of resources on our website if you want to learn more about options.

Inside the next video, I will show you step-by-step how to protect your stocks that have options.

Thank you for watching this video, I'm your host Christina, and I'll see you in the next video.