The *SimpleHedge* Strategy

An Understandable Approach to Protecting Capital for ETF/Mutual Fund Investors

By

Ulli G. Niemann

The *SimpleHedge* Strategy

An Understandable Approach to Protecting Capital For ETF/Mutual Fund Investors

By

Ulli G. Niemann

1st Edition

Copyright © 2009 by Ulli G. Niemann

All rights reserved. No parts of this report shall be reproduced or transmitted by any means without written permission from the author. No liability is assumed with respect to the use of the information contained herein. Although every precaution has been taken in the preparation of this report, the author assumes no responsibility for errors or omissions. Neither is any liability assumed for damages resulting from the use of the information presented.

Introduction

With the financial markets facing the aftermath of the bursting mortgage/real estate/credit bubble, investors have increasingly become frustrated with the lack of market direction. The use of my proprietary Trend Tracking Indexes (TTIs) has helped thousands of readers, with large and small portfolios, to avoid the brunt of the bear market as it struck fast and furious in 2008.

If you have received this e-book from a friend, and are not familiar with our Trend Tracking methodology, you may subscribe to my free weekly newsletter or visit my blog for the latest updates and relevant information.

For the first half of 2008, the major indexes headed sharply south, with the S&P 500 losing almost 13%, and sliding into bear market territory on 6/23/08, according to my domestic TTI (Trend Tracking Index). Internationally, the bear struck back with a vengeance on 11/13/07, and we've been out of that arena ever since.

Our latest Domestic Buy cycle lasted only about a month (5/15/08 to 6/23/08) and, with the benefit of hindsight, appears to have been a bullish blowout before the down trend settled in. It turned out to be a classic whip-saw signal.

As we were approaching the 6/23/08 sell signal, I had no idea that things could get worse and that a market collapse was imminent. The rest is history as the S&P 500 lost over 38% in 2008, and many investors saw their portfolios drop anywhere from 40% to 50%.

We're now in February of 2009 and the bottom made on November 20, 2008 still holds, although I would expect it to be taken out before this bear market finally ends.

With the market having bounced off the bottom, the most frequently asked question from my newsletter's 20,000 readers has been whether there is a way to safely participate in "bottom fishing" in order to get a head start on any rally that might materialize.

Actually, there is a way via a simple hedging process using mutual funds and ETFs. I've been working on this approach since early 2008. However, when the markets melted down, I decided to delay the completion of this booklet. Having witnessed one of the worst market collapses in history, I wanted to test its impact on the hedging approach I was designing.

The results are described in the following chapters. Keep in mind that the market is continually evolving so this is, of necessity, a work in progress. I will add additional information as I uncover other possibilities and will announce those via my blog and weekly newsletter, so be sure to stay tuned.

Why Hedge?

The objective of using a simple hedging strategy is threefold:

1. After a market bottom has been formed, a well conceived hedge strategy allows us to re-invest safely at a point *prior* to our domestic Trend Tracking Index (TTI) generating a Buy signal.

2. It allows us to avoid the big disadvantage of bottom fishing, which is watching your portfolio getting another haircut as the markets bob and weave before sinking lower.

3. Hedging enables us to safely add a position once the markets have rallied substantially.

Fulfilling these is a tall order, indeed, but I believe that my hedge ideas, as outlined, will make it possible to sharply reduce the risk commonly associated with re-establishing investment positions when the market is even more unpredictable than usual, i.e., while the major trend is still down or while the markets are nibbling at new highs.

Before getting to the specifics, however, let's look at some basics.

Avoiding Complexity

If you search on Google for the word hedging, you'll get over 7 million hits. I am certain that there are some excellent hedge strategies available, but for most of us they are too complicated, and you may not have the knowledge or software to execute a sophisticated strategy.

Since *complicated* and *cumbersome* are two words that I try to avoid in my business life as an investment advisor, I rejected what my search revealed and decided to design my own approach. After a significant amount of thought and analysis, I came up with a system that can be easily duplicated by anyone with access to the internet. It is based on one of my favorite lines by the great Michelangelo, who said "*simplicity is the ultimate sophistication*."

This booklet shows you, in understandable terms, how to execute a hedge strategy that I believe may have a large impact on how many people may invest their portfolios in the future.

Let's get started by defining what a hedge is.

What is a Hedge?

According to the definition from Investopedia, in investing, to hedge means:

> *Making an investment to reduce the risk of adverse price movements in an asset. It consists of taking an offsetting position in a related security.*
>
> *An example of a hedge would be if you owned a stock, then sold a futures contract stating that you will sell your stock at a set price, therefore avoiding market fluctuations.*
>
> *Investors use this strategy when they are unsure of what the market will do. A perfect hedge reduces your risk to nothing (except for the cost of the hedge).*

The obvious question is how can you make money when a perfect hedge reduces your risk to nothing? In other words, you gain on one side the exact amount that you are losing on the other.

Aha, that's where the imperfect market place comes into play.

We will look at some examples of how a hedge can work to your advantage. However, let's define some terms and conditions that will be used so we are all on the same page.

Parameters and Glossary of Terms

The following concepts and terms will be used throughout this booklet, so please familiarize yourself with them. If they seem complex at first, take heart. You will be surprised how simple they become as we start working with them.

1. **Beta**: The beta describes how the expected return of a mutual fund/ETF is correlated to the financial market as a whole. The financial market is usually represented by the S&P 500, which has an underlying beta of 1.0.

If you select a mutual fund/ETF with a beta of 1.2, it means that during up markets, this fund/ETF is supposed to outperform the S&P by 20%, while during down markets it will theoretically lose 20% more than the index. You can find out about the beta by visiting the risk section of your favorite financial site.

For example, if you click on the link http://finance.yahoo.com/q/rk?s=CVGRX, you will be able to see that the fund CVGRX has a beta of 1.50. While there, you can change the ticker symbol and find out the Beta value for any fund/ETF you are interested in.

2. **Inverse funds and ETFs:** With the proliferation of some 700 ETFs over the past few years, it's become easier than ever to "short" the market by simply buying an index that will do that for you. One of those inverse indexes, which I am using throughout this booklet, is SH. It performs inverse to the S&P 500.

3. For this study, **ETF trading fees** have been ignored to better focus on the hedging principles.

4. **Identification of Funds.** The funds used throughout this study are referred to as Fund A and Fund B. These were selected randomly, and they ended up performing well, but may not be appropriate for future use. So that readers do not indiscriminately jump on these funds, I have not disclosed their ticker symbols. However, later on, you will learn how to make appropriate selections.

Testing the Hedge Methodology

Theories are fine and good, however, I wouldn't put my money on a good sounding theory unless I knew it had been extensively tested. So, I have gone back through many periods of this century and applied my approach to hedging in just about all of the extreme market conditions I could come up with.

I have not attempted to find periods in time that would be favorable to my hedge approach (curve fitting), but simply have gone with the flow. What follows, are some of my results, good and bad, as I discovered them. As you will see, you can build a simple spreadsheet and do some back testing yourself and see what you come up with. It's very easy to follow my guidelines and use them in conjunction with my free weekly StatSheet. I do encourage you to read the whole booklet first, though, so you have as broad an understanding of the approach as possible.

The following sections deal with the final results and how to use this strategy, but they do not show every test that I have run. As a reader, you most likely are more interested in the "how to use it" rather than knowing every piece of research I've done. Rest assured, I have tested, re-tested, and applied this approach very thoroughly. My primary intention was less about coming up with a brilliant plan that would dazzle people and get me lots of praise, and much more about finding a methodology that would serve my clients and safely bring us extra profits. Before I was

willing to invest their money—and mine—in this approach, I wanted to make certain it was reliable.

Here, then, is a 5-step process to hedging.

Step1: Finding The Trend

Similar to our conventional Trend Tracking Index (TTI), where we try to locate the *long-term trend line*, we need to find out first where the *short-term trend* is before we can set up a hedge so that the odds of success are in our favor. What follows below is my step-by-step thinking, without the benefit of hindsight, in using this approach as the year 2007 came to an end.

It's Christmas 2007, and I am just reviewing the Domestic TTI (see Figure 1), which has been making new highs after a sell-off in November:

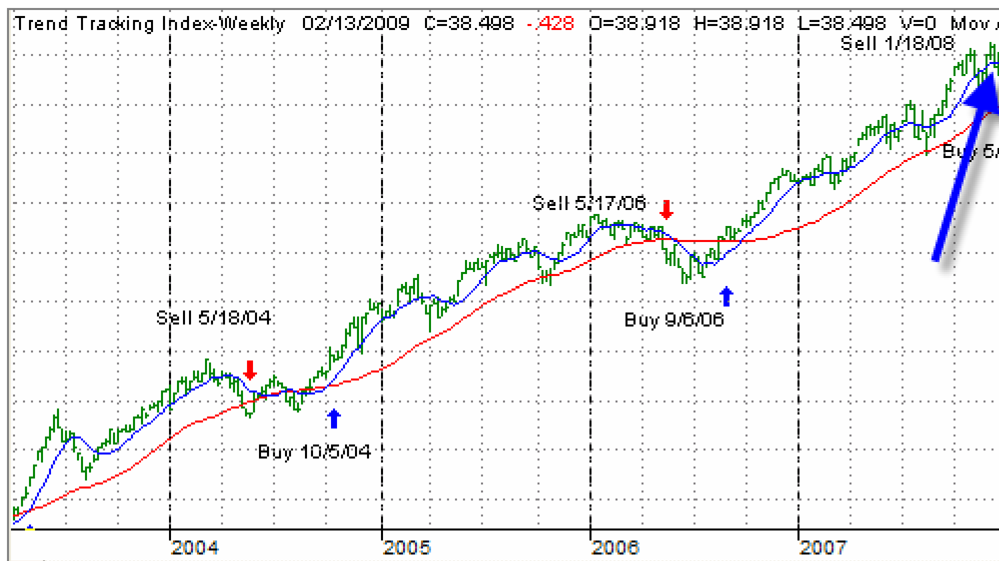

Figure 1

The domestic TTI (green) is still far above the long-term trend line (red), but also hovers above the short term trend line (blue), which is based on a 10-week simple moving average.

We are still in a domestic buy mode, but I have some cash available from positions I recently sold. My first requirement for setting up a hedge, the TTI being above the short-term trend line, has been fulfilled. On to step 2.

Step2: Locating An Appropriate Mutual Fund/ETF

My preference for setting up a hedge is to use some mutual funds on the long side, which are offset with an ETF on the short side. From past experience, I have found that at major turning points, say a rally after a bear market, mutual funds usually outperform ETFs.

Looking at my StatSheet dated 12/27/2007, the following picture emerges:

Domestic Funds-Top 100 as of 12/27/2007

Ticker	Fund Name	Orientation	M-Index	4 wk	8 wk	12 wk	YTD
PZD	PowerShares Cleantech Portfolio	Small Growth	16	5.55%	7.94%	8.53%	42.23%
LAGRX	Loomis Sayles Aggressive Growth Ret	Mid-Cap Growth	13	3.78%	4.07%	6.66%	38.91%
QUAGX	*Quaker Strategic Growth A	Large Blend	10	3.78%	2.65%	5.64%	26.14%
JAENX	Janus Enterprise	Mid-Cap Growth	9	4.64%	2.40%	2.43%	24.99%
TTOPX	Turner Concentrated Growth Instl	Large Growth	9	2.02%	0.47%	2.31%	32.96%
ICBMX	ICON Materials	Mid-Cap Value	8	1.36%	0.00%	-0.84%	31.49%
ALARX	*Alger Capital Appreciation Instl I	Large Growth	8	1.68%	-1.31%	1.72%	31.63%
LGRRX	*Loomis Sayles Growth A	Large Growth	8	3.49%	1.51%	3.35%	21.88%
TLCGX	Turner Large Cap Gr Opp I	Large Growth	8	2.16%	-0.24%	0.98%	28.05%
NOMCX	Northern Mid Cap Growth	Mid-Cap Growth	7	1.26%	0.22%	0.71%	24.35%
BSMAX	Brazos Small Cap N	Mid-Cap Growth	7	1.62%	-0.90%	-2.75%	30.65%
ALMRX	*Alger MidCap Growth Institutional I	Mid-Cap Growth	7	1.99%	-1.13%	0.00%	27.89%
TEQAX	*Touchstone Large Cap Growth A	Large Growth	7	1.41%	-1.01%	-0.40%	26.42%
TMGFX	Turner Midcap Growth	Mid-Cap Growth	7	2.86%	-0.19%	-0.47%	24.44%
LCORX	Leuthold Core Investment	Moderate Allocation	6	1.20%	1.33%	3.38%	16.36%
LSLTX	Leuthold Select Industries	Mid-Cap Growth	6	2.47%	1.38%	0.31%	18.65%

Figure 2

As you can see in Figure 2, only one ETF is among the highest ranked mutual funds. To prove a point, I drop way down the list and select Fund A (from a 50 something ranking) and Fund B (from a 100 something ranking).

I check the link http://finance.yahoo.com/q/rk?s=CVGRX, as mentioned in the glossary, and find out the following:

Fund A is a *Large Value* fund with a beta of 1.19 and Fund B is a *Mid-Cap Growth* fund with a beta of 1.22. Since both values are larger than 1, they qualify for my hedge set up. You can use more than 2 funds or different orientations, it does not matter.

Step 3: Living With The Hedge

For the sake of this exercise, I've decided to set up a scenario where I allocate 20% of a particular $100k portfolio for this hedge. So on December 31, 2007, I set it up as if I were buying $5k worth of Fund A, $5k worth of Fund B and $10k of my short position in SH. That scenario looks like this:

				12/31/2007	
			Sh's	Purchase	Basis
SH	10,027		165	12/31/2007	60.77
Fund A	5,000		88	12/31/2007	56.82
Fund B	4,996		196	12/31/2007	25.49
	20,023				

Figure 3

Moving into January 2008, the markets softened and a domestic Sell signal was generated on January 18. We liquidated our main positions, and this would have been as good a time as any to get out of the hedge as well.

However, since I'm in testing mode, I decide to see what would have happened to the hedge had I left it in place.

The volatility and downtrend continued, then a new buy signal materialized on 5/15/08, during which we only made a small commitment. Good thing, because the following whipsaw generated a Sell signal again on 6/23/08 at which time we sold the few remaining holdings we had not been stopped out of.

From 12/31/07 to our Sell signal on 6/23/08, this is what the hedge performance looked like:

				12/31/2007		6/23/2008				
			Sh's	Purchase	Basis	Price		G/L in %	G/L in $s	High
SH	10,027		165	12/31/2007	60.77	66.77		+9.87%	990	
Fund A	5,000		88	12/31/2007	56.82	57.87		+1.85%	92	
Fund B	4,996		196	12/31/2007	25.49	25.13		-1.41%	-71	
	20,023									
Dividends:										
SH	0.255		165	3/25/2008					42	
							Net Hedge:	------------>	1054	5.26%
S&P 500				12/31/2007	1,468	1,318		-10.22%		

Figure 4

Let's review Figure 4. With the market, as measured by the S&P 500, having dropped -10.22% for this period, it was our short position (SH) that saved the day by gaining +9.87%. Actually, both mutual funds held up really well considering the big picture.

Tallying up all the gains and losses (G/L) and dividends paid, this hedge showed an unrealized gain of +5.26%. This is really a spectacular performance given the circumstances at the time.

Please note that inverse funds, such as SH, are supposed to show the opposite performance of the S&P 500, but there will be discrepancies. Sometimes they work in your favor, and sometimes they don't. In this case, there was a slight imbalance as SH gained +9.87%, while the underlying index lost -10.22%.

It gets better.

How Low Can You Go?

Fast forward to the second half of 2008—which many investors wish never happened as the market dropped like a rock over a period of four months and devastated many portfolios. Because of my overall trend tracking methodology, my clients and I spent our time watching the debacle unfold from the safety of our money market accounts.

The lows were made on November 20, 2008. At that moment, our hedged position looked like this:

				12/31/2007		11/20/2008				
			Sh's	Purchase	Basis	Price		G/L in %	G/L in $s	High
SH	10,027		165	12/31/2007	60.77	103.63		+70.53%	7072	
Fund A	5,000		88	12/31/2007	56.82	22.85		-59.79%	-2989	
Fund B	4,996		196	12/31/2007	25.49	12.97		-49.12%	-2454	
	20,023									
Dividends:										
SH	0.255		165	3/25/2008					42	
SH	0.200		165	6/24/2008					33	
SH	0.181		165	9/24/2009					30	
Fund A	0.161		88	6/26/2008					14	
Fund B	0.158		88	9/23/2008					14	
							Net Hedge:	------------>	1762	8.80%
S&P 500				12/31/2007	1,468	752		-48.77%		

Figure 5

Look at these numbers! The hedge is now showing an unrealized gain of +8.80%, while the S&P 500 has lost a mind-boggling -48.77%.

The obvious hero in this scenario was our short position (SH), which showed an amazing gain of +70.53%. Notice the discrepancy to the index of -48.77%? They're supposed to cancel each other out, but in this case our hedge clearly benefited tremendously from this imbalance. (It doesn't always happen this way, so don't count on that.)

Bouncing Off The Lows

From the November lows, we saw sharp bounces, which are typical of bear markets, as well as jaw dropping moves back to the downside. Closing out the year, on December 31, 2008, our hedge position looked as follows:

						12/31/2008				
			Sh's	Purchase	Basis	Price		G/L in %	G/L in $s	High
SH	10,027		165	12/31/2007	60.77	72.02		+18.51%	1856	
Fund A	5,000		88	12/31/2007	56.82	29.53		-48.03%	-2402	
Fund B	4,996		196	12/31/2007	25.49	16.27		-36.17%	-1807	
	20,023									
Dividends:										
SH	0.255		165	3/25/2008					42	
SH	0.200		165	6/24/2008					33	
SH	0.181		165	9/24/2009					30	
SH	11.983		165	12/23/2008					1977	
Fund A	0.161		88	6/26/2008					14	
Fund A	0.158		88	9/23/2008					14	
Fund A	0.188		88	12/10/2008					17	
							Net Hedge:	------------>	-226	-1.13%
S&P 500				12/31/2007	1,468	903		-38.49%		

Figure 6

By the end of the year, our hedge had surrendered all gains and was showing a -1.13% loss. Looking at the big picture, however, this is quite an accomplishment when considering market losses as a whole. There is probably no investor out there, who would not like to trade his own portfolio performance for the results of this simple hedge.

Again, my recommendation is to always work with a sell stop discipline. While I demonstrated the effects of a mindless buy and hold hedge, a more appropriate way would have been to use my 7% trailing stop loss approach. (See my blog, website, and newsletters for more on this, if you're interested.)

Take a look at figure 5 again, which showed a maximum gain for the year of +8.80%. As these profits were reduced by 7%, an exit point would have been around the +1.8% area. That way, the unrealized profit would have been turned into a gain and not a loss—as minor as it turned out to be.

As I mentioned before, my preference is to use no load mutual funds for my long positions for the reasons stated. But, what if you would rather work with ETFs exclusively? Figure 7 shows the same scenario as Figure 6, except I randomly selected 2 ETFs for the long side of the hedge. Take a look:

				12/31/2007		12/31/2008				
			Sh's	Purchase	Basis	Price		G/L in %	G/L in $s	High
SH	10,027		165	12/31/2007	60.77	72.02		+18.51%	1856	
IYT	5,038		62	12/31/2007	81.25	63.31		-22.08%	-1112	
IJK	4,991		56	12/31/2007	89.12	55.45		-37.78%	-1886	
	20,055									
Dividends:										
SH	0.255		165	3/25/2008					42	
SH	0.200		165	6/24/2008					33	
SH	0.181		165	9/24/2009					30	
SH	11.983		165	12/23/2008					1977	
IYT	0.232		62	6/25/2008					14	
IYT	0.162		62	9/24/2008					10	
IYT	0.252		62	12/23/2008					16	
IJK	0.112		56	6/24/2008					6	
IJK	0.171		56	12/24/2008					10	
							Net Hedge:	------------>	996	4.97%
S&P 500				12/31/2007	1,468	903		-38.49%		

Figure 7

There you have it. In this case, the ETFs performed better and showed a positive return for the year.

Heading Into 2009

As you can see in Figure 6, our 3 positions showed varying results, which means that at the end of 2008, I had to rebalance to make sure that my holdings were equally divided between a 50% long position and a 50% short position.

The market surged into this year with a similar volatile pattern and the overall major trend heading lower. In other words, we're still in bear market territory.

Having my positions rebalanced, my hedge is now showing the following unrealized gains from 12/31/08 to 2/13/09:

				12/31/2008		2/13/2009				
			Sh's	Purchase	Basis	Price		G/L in %	G/L in $s	High
SH	10,011		139	12/31/2008	72.02	77.32		+7.36%	737	
Fund A	4,991		169	12/31/2008	29.53	28.62		-3.08%	-154	
Fund B	4,995		307	12/31/2008	16.27	16.42		+0.92%	46	
	19,996									
Dividends:										
							Net Hedge:	------------>	629	3.15%
S&P 500				12/31/2008	903	827		-8.43%		

Figure 8

Now we're back into positive numbers as the S&P 500 dropped -8.43% over the first 6 weeks of the year and our hedge gained +3.15%.

Let's see how our ETF alternative had fared during the same period:

				12/31/2008		2/13/2009				
			Sh's	Purchase	Basis	Price		G/L in %	G/L in $s	High
SH	10,011		139	12/31/2008	72.02	77.32		+7.36%	737	
IYT	5,001		79	12/31/2008	63.31	52.93		-16.40%	-820	
IJK	4,991		90	12/31/2008	55.45	53.65		-3.25%	-162	
	20,003									
Dividends:										
							Net Hedge:	------------>	-245	-1.23%
S&P 500				12/31/2008	903	827		-8.42%		

Figure 9

Here the ETFs lagged behind slightly. Nevertheless, given last year's positive performance in the face of the meltdown, I'm still ahead.

The bottom line is that setting up a 50/50 hedge will do a lot more for you if the markets head south than hanging on to an outright long position. No question about that. Since the first example had us setting up the hedge close to the top of the market, how do we use it at a market bottom, kind of like what Figures 8 and 9 demonstrated?

Bottom Fishing

I received lot of emails after the markets made a bottom last November asking if I would change the entry signals for my Trend Tracking Indexes (TTIs). I suppose the majority of investors were eager beavers trying to get onboard early to ride the alleged gravy train back to the top, since our domestic TTI was still some 12% away from generating a new Buy signal.

Let's take a look again at the TTI and its trend lines:

Figure 10

For the purpose of doing some bottom fishing, we need to see a rebound off the bottom with the price (green) having moved above the short-term trend line (blue). This was the case in December 2008, which justified a new hedge set up as shown in Figures 8 and 9. However, as of this writing the price is -2.14% below the blue line.

This means that there is weakness in the market and until the short-term trend reverses, I will stay aside and not put on any new hedges. However, our rebalanced hedge from 12/31/08 is still in place. Should I sell it?

When To Close Out A Hedge Position

My belief is that you should close out any position at any time you are no longer comfortable with it. I use a similar trailing stop loss rule as I do with all of my mutual fund/ETF holdings:

If a Hedge drops more than 7% from its high since I bought it, I liquidate.

Take a look again at Figure 8. It's showing a current gain of +3.15%. If that number drops by 7%, I'm out! No questions asked.

Step 4: Supercharging Your Hedge

One of the main reasons I set up a hedge is to get into the market early and prior to our domestic TTI signaling a Buy, while controlling downside risk.

As you saw from the previous example, the downside actually worked to our advantage. If the markets move higher, and eventually generate a new domestic Buy signal, what should I do with my hedge position? While the hedge will gain in bullish periods as well, it will not perform nearly as well as an outright long position.

So my next step will be to liquidate my short position (SH) as soon as our domestic TTI has signaled a Buy. That will make me net long. Since this signal confirms a major trend change, I will also add to my existing long positions with fund/ETF choices from my StatSheet.

If at anytime the markets retreat and signal a Sell, I can liquidate my long exposure altogether or sell a portion and set up a hedge again by buying an equal amount of SH.

You may be wondering, why I don't advocate the same approach when we're getting a Sell signal. In other words, why don't I go net short to take advantage of the market drops. This can work well for investors with an aggressive component in their risk profile. I have found that most people don't do well emotionally being short and then watching the market stage a 600 point rally.

To each his own! You have to decide what kind of investor you are; I only provide you with the tools that enable you to make better decisions.

Looking At The Big Picture

The idea of buying and holding an investment no matter what the circumstances received the final nail in the coffin in 2008. That was when people were forced to realize not only the insanity of it but also to consider the years that now will be wasted trying to make up last year's devastating losses.

Even though I have set up a trend tracking system with clearly defined rules, I consistently find that people often will not follow them. I have heard all of the reasons why, like, "my dog was pregnant," (Honest, a new client told me that!) "we were out of town," "my daughter had a baby," and so on. It's just the way it is.

Using a hedge system will protect you more from downside risk than any other approach I know of. Once your hedge is set, and you "forget" to make adjustments or initiate new buys or sells for any of the above mentioned reasons, and others, you can at least be assured that market action will not kill your portfolio.

You may miss an opportunity to go net long to enhance your profits, but you're very well covered against downside risk if you follow the rules of setting up your hedge properly to begin with.

If you're the kind of person who has other priorities in life, let me show you what would have happened to a fully hedged $100k portfolio during the first 8 years of this century, if you had done nothing else but rebalance your hedge once a year and used the same funds for the entire period.

Please note that ETFs were not available earlier in this century, so I have substituted the appropriate bear mutual fund.

Year	Beginning Balance	Hedged Growth	Value	S&P 500 Growth	Value
2001	100,000	-1.48%	98,520	-13.03%	87,163
2002		-6.23%	92,382	-23.34%	66,819
2003		15.47%	106,674	26.39%	84,453
2004		6.16%	113,245	8.99%	92,045
2005		7.49%	121,727	2.97%	94,779
2006		2.27%	124,490	13.62%	107,687
2007		5.74%	131,636	3.53%	111,489
2008		-1.13%	**130,148**	-38.49%	**68,577**

Figure 11

This simple buy and hold (which I do not advocate) hedged growth portfolio grew to $130,148, while the S&P 500 contracted sharply and pulled the original $100,000 down to $68,577.

What this clearly demonstrates is that *it is far more important to guard a portfolio against downside risk than trying to maximize upside potential*. If you would have included the signals from my long-term domestic TTI, you could have improved the returns considerably.

As much as it pains me to say it, buy and hold done right via a simple hedge can outperform the majority of professional money managers when combining bull and bear market results. Of course, while that may give you satisfaction, it's more important to implement a combination of long-term trend tracking along with a short-term hedging strategy to not only improve returns but also help you sleep better at night when the markets are having a tizzy fit.

Step 5: Don't Hedge Apples With Oranges

I am sure that you may find this entire concept of hedging very appealing, especially once you realize that it will take the knot out of your stomach when watching the markets go opposite of what you've been hoping for.

However, let me give you some direction as to which short position to hedge with which kind of mutual fund, and then I'll tell you about a mistake I made with a position I still own.

You need to hedge like with like. For example, you don't want to hedge oil or other sector ETFs against the S&P 500 because there is no correlation. In this booklet, I have focused exclusively on the use of SH (short S&P 500) against "*widely diversified domestic equity funds/ETFs*."

To my way of thinking a fund labeled in its profile as "Large Blend" should be diversified, but that is not necessarily so. Be sure read the profile and stay away from funds/ETFs labeled as "nondiversified." Again, if you follow my rules, this type of mistake won't kill you, but it can be avoided.

Here's what I did with one of my portfolios on 12/31/2008. The short-term trend was up, so I initiated the following hedge:

			Sh's	Bought	Basis	Curr. Price		G/L in %	G/L in $s	High	Off High
SH	9,976		138	12/31/2008	72.29	77.32		+6.96%	694	80.29	-3.70%
PFF	9,999		346	12/31/2008	28.90	23.50		-18.69%	-1868	31.24	-24.78%
	19,975										
Dividends:											
PFF				2/2/2009					62		
							Net Hedge:	------------>	-1112	-5.57%	
S&P 500				12/31/2008	903	827		-8.43%			

Figure 12

As you can see, my choice for the long position was PFF, which is the U.S. Preferred Stock Index, which currently yields 10.77%. By 1/12/09, this position had gained +4.95% and by 2/5/09 it had lost -6.15% and has been teetering on the brink of a Sell signal. Technically, I should have sold already, but since I was in testing mode, I have held on.

This ETF is labeled "Large Blend" but it is also noted that it is "nondiversified." It behaved almost like a sector fund as the financials picked up more downward momentum. This hedge represents only 20% of the portfolio's value, so my risk is limited to -1.4% of the total if I end up selling at the -7% level.

While that's an outcome I can obviously live with, my point is that you need to make sure that you use appropriate funds to hedge against. I made that mistake and hopefully by mentioning it to you here, you can avoid making it.

The Long and the Short of it

Look at Figure 5 again. A question that might have come up in your mind is that the hedge was ahead on November 20th by +8.80% for the year, yet we closed out 2008 with a -1.13% loss (Figure 6), while the markets staged a year-end rally. Why did this rally wipe out all of the gains? Does the hedge fail in a bullish scenario?

No it does not and the reason is simple. If you multiply the shares owned by the price on November 20th and compare the total long and short values at that moment in time, you will find the following imbalance:

Long positions: Fund A value plus Fund B value = $4,553
Short position: Total value of SH = $17,099

That means we only have 21% of our invested portfolio in long positions, while our short position has ballooned to 79%. This was obviously caused by the tremendous drop in the market. If the trend continues to go down, we would benefit greatly, however, if the trend reverses and heads higher, we'd be at a disadvantage. The latter is what obviously happened, causing the unrealized gain to turn into a small unrealized loss.

To support the importance of being properly balanced (50/50), I ran the numbers. They confirm that the hedge would have gained +4.36% in value from 11/20/08 to 12/31/08 as opposed to dropping from +8.80% to -1.13% for the same period if left unadjusted.

That's why it is important to rebalance to the 50/50 level once positions become too lopsided. There is no particular percentage I can recommend but, personally, I would make adjustments once I get to the 60/40 level or so.

Reviewing the 5-Step Summary

To get started on your way to setting up a successful hedge, be sure to follow the 5 steps as outlined above:

Step 1: Find the short-term trend (10-week average) by reviewing my domestic Trend Tracking Index (TTI) in the weekly StatSheet. If the price line (green) is trading above the trend line (blue), we have a green light, and you can go to step 2. If the price line remains below the trend line, it's time to stay aside.

Step 2: Locate some appropriate mutual funds by reviewing the listings in section 1 of the StatSheet. After you have made your selections, be sure to confirm that the Beta is larger than 1 and that your funds are compatible with your short position (see Step 5).

Step 3: Track your hedge and execute a sell stop if your Net Hedge return drops off its high by more than 7%, since you put on the position.

Step 4: Once our long-term domestic TTI signals a buy (when the green price line climbs above the red trend line), sell your short (SH) position and become net long. If the uptrend stays in place, add more positions but make sure to set up a trailing stop loss.

Step 5: Be sure that you have selected compatible funds with your short position as outlined in the section. "Don't hedge apples with oranges."

Reducing Agony

Having spoken and emailed with thousands of my newsletter readers, I am familiar with the agony many go through when making buy or sell decisions. The mental gymnastics involved of making decisions range from listening endlessly to the cheerleaders on CNBC, researching to be sure the chosen manager of the fund you are considering likes the same dogs you do, and confirming that Morningstar gives their approval via a (useless) 5-star ranking.

Then there is the timing factor. Should I have bought last week, or will this week be better or should I pull the trigger on my wife's birthday? That way she might give me more slack, if I lose money again…

None of these things should really matter, but they do to a lot of investors.

When setting up a hedge to ease into the market, your investment life will be a lot easier. If you stick to the rules as outlined, you won't be anxious at all as you are setting up the hedge, because you know that you're covered in case the markets make a sudden unexpected move.

You will also find that, once you have the same amount of long and short positions in the market, it's much easier to sell the short one and become net long or vice versa if the trend tracking rules determine such action to be necessary. I do this for a living, and I have consistently found this to be true.

Once you are ready, and the trading rules call for you to set up a hedge, start easy by allocating 20% of your portfolio at first, as I have shown in my examples. Once your comfort level grows, you can always add to it.

Share And Spread Your Experience

I like to hear about your experiences, so feel free to share them with me via email or by posting them to my blog when I cover that specific subject.

If you like my ideas, and you find them valuable, please pass on this e-booklet to as many people as possible. If you have contacts with any media editors, send them a copy as well.

There are still tens of millions of investors, who struggle every day trying to survive treacherous market conditions. The more people you and I can reach, the more people will be helped in the process.

A Work In Progress

I hope that these thoughts have stimulated you to do some research on you own. If you develop some of your own ideas, feel free to share them with me, and I will give you credit if I publish them. I will continue my work and will share other findings by adding them to this booklet.

If you are an investor who is intrigued by these concepts but are too busy to implement them on your own, feel free to contact me if you'd like to take advantage of our management services.

My email is ulli@successful-investment.com, and I can be reached at 714-841-5804.

Due to my schedule, I prefer an initial contact via email.

You have my wishes for the very best of success with your investing.

About The Author

Ulli G. Niemann is a Registered Investment Advisor and has been advising clients on money matters since the 1980s. His advisory business focuses on helping investors grow their capital via his proprietary trend tracking methodology. He publishes a free weekly newsletter that is currently read by over 20,000 subscribers (www.successful-investment.com).

He writes a daily blog called the Wall Street Bully (http://thewallstreetbully.blogspot.com/) and lends a helping hand to investors who are looking to preserve their wealth and capital by using a sensible non-Wall Street approach to better control their financial destiny.

Ulli can be reached at 714-841-5804 or via email at ulli@successful-investment.com. He's available by appointment only for meetings either at his office in Huntington Beach, California or his location in Maui, Hawaii.