Hedge Definition and How It Works in Investing

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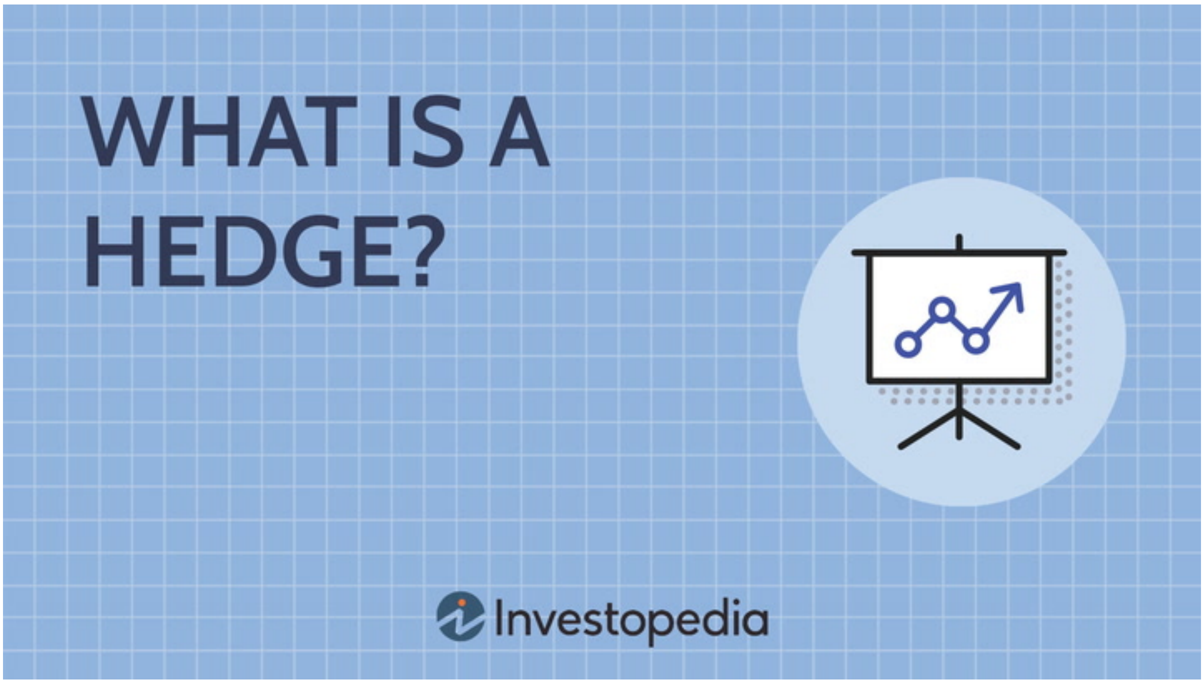


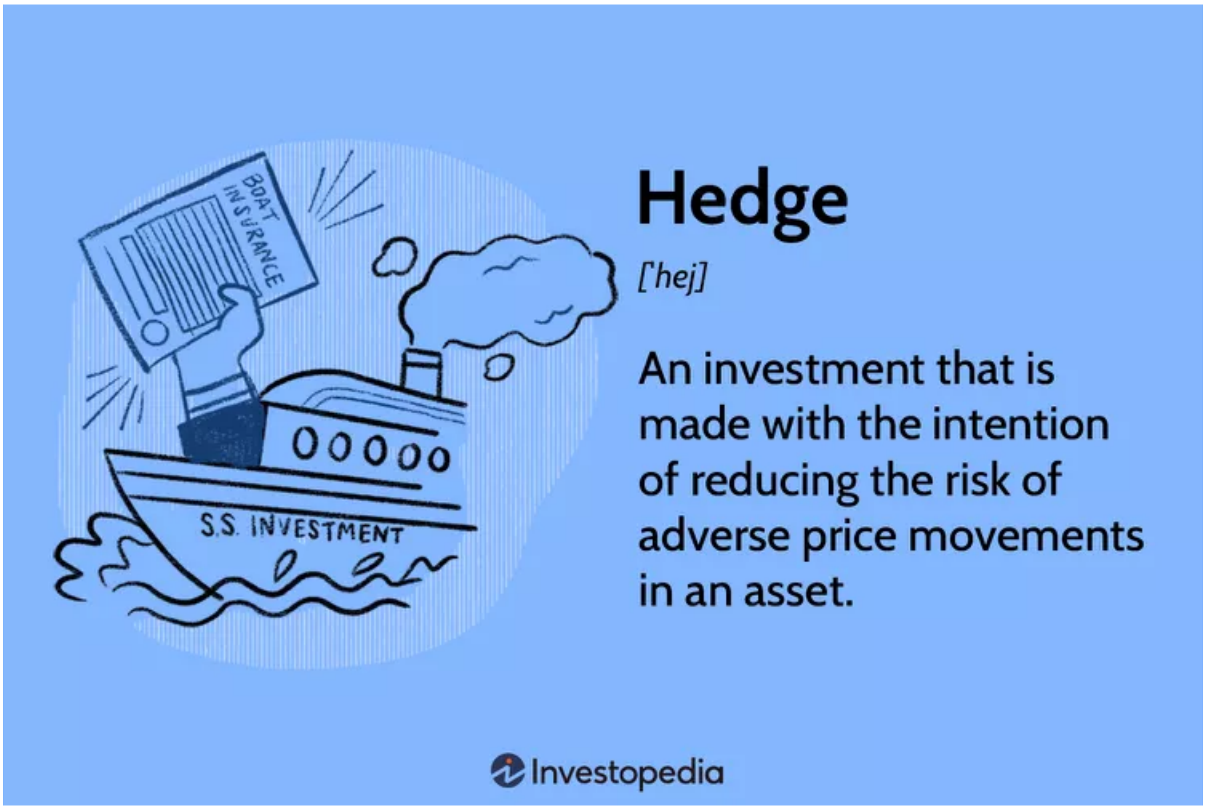
What Is a Hedge?

A hedge is an investment that is selected to reduce the potential for loss in other investments because its price tends to move in the opposite direction. This strategy works as a kind of insurance policy, offsetting any steep losses in other investments.

The term hedging can be used to describe diversifying a portfolio by buying shares in a conservative bond fund to offset potential losses in more volatile stock funds.

In the financial world, where traders constantly buy and sell assets, some of them highly risky, hedging typically involves trading in derivatives, which can be effective hedges because their relationship with their underlying assets is clearly defined.

- A hedge is a strategy that seeks to limit or offset risk in an investment or a portfolio of investments.
- A widely used hedging technique involves buying derivatives.
- Portfolio diversification is a type of hedge. Buying both cyclical and countercyclical stocks is an example.



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How a Hedge Works

Using a hedge is a bit like taking out an insurance policy. If you own a home in a flood-prone area, you can protect it from the risk of flooding—hedge it, in other words—by taking out flood insurance. You cannot eliminate the risk of a flood, but you mitigate the financial losses you could incur.

Similarly, if you invest in a hot technology company with the firm belief that its business will thrive over the next quarters, you might also invest in a solid consumer staple stock just in case you're mistaken.

The Downside to a Hedge

Hedging isn't free. In the case of the flood insurance policy example, the monthly payments add up, and if the flood never comes the policyholder gets nothing. Still, most people would choose to limit their losses.

In the world of professional investing, hedging works in the same way. Investors and money managers use hedging practices to reduce and control their exposure to risks. They use various tools for the purpose, many of them based on derivatives.

FAST FACT

A perfect hedge eliminates all risk in a position or portfolio. In other words, the hedge is 100% inversely correlated to the vulnerable asset. This is more an ideal than a reality and even the hypothetical perfect hedge is not without cost.

Hedging With Derivatives

Derivatives are financial contracts whose price depends on the value of some underlying security. Futures, forwards, and options contracts are common types of derivatives contracts.

The effectiveness of a derivative hedge is expressed in terms of its delta, sometimes called the hedge ratio. Delta is the amount that the price of a derivative moves per $1 movement in the price of the underlying asset.

The specific hedging strategy, as well as the pricing of hedging instruments, depends largely upon the downside risk of the underlying security against which the investor wants to hedge. Generally, the greater the downside risk, the greater the cost of the hedge.

Downside risk tends to increase with higher levels of volatility and over time; an option that expires after a longer period and is linked to a volatile security will be more expensive as a means of hedging.

adjusted to create a less expensive option that offers less protection, or a more expensive one that provides greater protection.

FAST FACT

The hedge fund gets its name from the wide latitude given a hedge fund manager to trade in alternative investments and use risky strategies such as leverage (borrowing to invest) to achieve results.

Example of Hedging With a Put Option

A common way of hedging in the investment world is through put options. Puts give the holder the right, but not the obligation, to sell the underlying security at a pre-set price on or before the date it expires.

For example, if Morty buys 100 shares of Stock PLC at $10 per share, he might hedge his investment by buying a put option with a strike price of $8 expiring in one year. This option gives Morty the right to sell 100 shares of that stock for $8 anytime in the next year.

Let's assume he pays $1 for the option, or $100 in premium. If the stock is trading at $12 one year later, Morty will not exercise the option and will be out $100. He's unlikely to fret, though, because his unrealized gain is $100 ($100 including the price of the put).

If the stock is trading at $0, on the other hand, Morty will exercise the option and sell his shares for $8, for a loss of $300 ($300 including the price of the put). Without the option, he stood to lose his entire investment.

Hedging Through Diversification

Strategically diversifying a portfolio to reduce certain risks can also be considered a hedge. For example, Rachel might invest in a luxury goods company with rising margins. She might worry, though, that a recession could wipe out the market for conspicuous consumption. One way to combat that would be to buy tobacco stocks or utilities, which tend to weather recessions well and pay hefty dividends.

luxury goods maker might thrive, but few investors would be attracted to boring countercyclical stocks, which might fall as capital flows to more exciting places.

It also has its risks: There is no guarantee that the luxury goods stock and the hedge will move in opposite directions. They could both drop due to one catastrophic event, as happened during the financial crisis.

Spread Hedging

For investors in index funds, moderate price declines are quite common and highly unpredictable. Investors focusing on this area may be more concerned with moderate declines than severe ones. In these cases, a bear put spread is a common hedging strategy.

In this type of spread, the index investor buys a put that has a higher strike price. Next, she sells a put with a lower strike price but the same expiration date.

Depending on how the index behaves, the investor thus has a degree of price protection equal to the difference between the two strike prices (minus the cost). While this is likely to be a moderate amount of protection, it is often sufficient to cover a brief downturn in the index.

Hedging and the Everyday Investor

Most individual investors don't trade derivative contracts. Investors with a long-term strategy, such as those saving for retirement, can ignore the day-to-day fluctuations of the markets.

For investors who fall into the buy-and-hold category, there may seem to be little or no reason to learn about hedging. Still, because large companies and investment funds tend to engage in hedging practices regularly, and because these investors might follow or even be involved with these larger financial entities, it’s useful to understand what hedging entails to comprehend the actions of these larger players.

making a trade in another that is likely to move in the opposite direction.

What Is an Example of Hedging?

Hedging is commonly used to offset potential losses in currency trading. A foreign currency trader who is speculating on the movements of a currency might open a directly opposing position to limit losses from price fluctuations. Thus, the trader retains some upside potential no matter what happens.

Is Hedging an Imperfect Science?

Yes. A perfect hedge would eliminate all risk in a position or portfolio. In other words, the hedge is 100% inversely correlated to the vulnerable asset. This is purely hypothetical, but even the hypothetical perfect hedge has a cost that subtracts from its gain.

The Bottom Line

Hedging is an important financial concept that allows investors and traders to minimize various risk exposures. A hedge is effectively an offsetting or opposite position taken that will gain (or lose) in value as the primary position loses (or gains) value.

A hedge can be thought of as a sort of insurance policy on an investment or a portfolio. These offsetting positions can be achieved using closely related assets or through diversification.

Among professional traders, the most common and effective hedge uses derivatives such as futures, forward. or options contracts.

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