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Should I Be Hedging?

September 30, 2021

So far 2021 has been a good year for those who have stayed invested in equities. Although the major indexes are trading near all-time highs, beneath the surface there has been a significant amount of churn with many stocks trading greater than 10% off their 52-week highs and fewer above their 200-day moving averages. Moreover, we are smack dab in the middle of what historically have been a blustery couple of months for the stock market. September and October have traditionally been the weakest months of the year, with an average decline of -0.7% in the Dow Jones Industrial Average going back to 1900 and it has finished positive only 48% of the time. This does not mean we can't trade higher in the coming weeks and set new highs, but understanding the past helps us better intellectualize what is possible going forward. (Please see the chart below).

Dow Jones Industrial Average Performance (1900-2020)			
Month starting	Month ending	% times up	Average
Dec	Jan	66%	2.2%
Jan	Feb	59%	0.8%
Feb	Mar	52%	0.5%
Mar	Apr	64%	2.0%
Apr	May	59%	1.3%
May	Jun	53%	0.1%
Jun	Jul	60%	1.6%
Jul	Aug	63%	2.4%
Aug	Sep	58%	-0.1%
Sep	Oct	48%	-0.7%
Oct	Nov	63%	1.4%
Nov	Dec	72%	2.6%

Source: Charles Schwab Quarterly Market Outlook, SentimenTrader. 1900-2020.

Recently, headlines surfaced about Chinese property developer Evergrande potentially defaulting on its debt, and that caused a temporary swoon in the stock market. For many market participants, this was not among the numerous "worries" that investors had been facing thus far in 2021. Recall, the headlines have been consistently harping on a seemingly endless list of reasons to despair: interest rates, inflation, fed taper, Covid, Delta variant, government debt ceilings, tax changes, supply chain disruptions, U.S. departure from Afghanistan, etc. etc. We remind you, what moves the market or individual stock prices is not normally what is already "in the news," it's surprises that cause sudden changes to share prices. For example, potential decisions by Fed Chairman Jerome Powell and his colleagues at the Federal Reserve are most likely discounted into the market ahead of time, especially if that information is in the public domain for weeks and months. The ability of the capital markets to discount and anticipate is well documented. Thus, it's usually unexpected events that have the potential to cause dramatic moves. But as seasoned investors, we have come to grips with anticipating fiscal and monetary uncertainty and lately have gotten much better at handling Covid and what that means for both our personal and professional lives. All that said, while it still might feel like a dystopian world in many ways and all we can do is meet it head on. We're here to help guide you and hopefully make you better investors!

Given the constant drumbeat of red flags and uncertainties, we must make the best decisions we can to save and invest our hard-earned capital. Corda was established in 1999, but many of us have been engaged in the capital markets far longer than twenty-one years. A common question that rises from time to time is how to protect gains in a portfolio or, put another way, what steps an investor could take to avoid losses. Hopefully by now you have heard the refrain from Corda that the "typical" market correction in any given calendar year is about 14%. Also, more importantly, 5% downdrafts are common, usually occurring 2-3 times per year. We'd consider 5% to 14% type pullbacks temporary in nature, and the only way to create permanent losses is to sell when share prices are down that far. The difference between temporary losses and permanent losses is more about how investors deal with their emotions than it is about the long-term growth of real tangible assets. Businesses with real earnings power and an ability to distribute a portion of those earnings via dividends and concurrently use the remaining profits to generate high rates of return on invested capital are a powerful force that normally cannot be denied over the long run. But fear and greed are stronger forces and investors sometimes lose their footing when getting caught up in the moment.

So, what can an investor do if trying to "protect" a portfolio from temporary losses? Is it even possible? Well of course you can sell at any time - certainly if one is invested in the stock market knowing 5% and 10% corrections are common, one should probably not be invested if that level of volatility is going to cause you to do financial harm to yourself. On the flipside, you can attempt to buy puts or short stocks to gain when these securities decline in price. You would have to have a certain acumen to be a short seller and to do it successfully over time. Plus, short selling subjects you to theoretically unlimited losses if you are wrong, so it's a dangerous game to play.

For those who look to protect gains by hedging or buying put options, this is a fascinating subject mind you, and one we have experience with due to our fellow portfolio management team member Brian Raupp's formal experience in the pit at the Chicago Board of Options Exchange (CBOE). Hedging and trading options are often touted as a good way to "make money on Wall Street," but remember, the folks pushing these strategies are also the ones profiting by it. Brokers and others sponsor shows and advertise on major media outlets because it drives a good bit of business for them!

All that said, let's walk through a current example of what hedging a portfolio against a decline might look like. Let's set up some parameters. An investor is seeking to protect against a >10% decline in the stock market sometime over the next six months because of their concerns over the Federal Reserve raising interest rates or the Delta variant. So, they decide to buy puts on the S&P 500. Keep in mind, option contracts are sophisticated vehicles, and the prices of options move in unique ways that have correlations and dependencies on a multitude of inputs that will make them extraordinarily volatile over the time period in which you own them. We will keep this example as clean and straight forward as possible but let us assure you – it's far more complex! The goal here is to hedge against a greater than 10% decline in the next 6-month period – so we buy puts that are 10% out of the money that expire in six months. The current cost to implement this strategy based on the existing level of implied volatility in the market today is 3% of your portfolio. In dollar terms, it will cost $30,000 on a $1MM portfolio value. So, what happens next? You simply need the stock market to decline by at least 13% to break even. For example, let's say you accurately predicted a decline, but were off by the magnitude. Assume in the most punishing way that the market was down by 9% by the time your options expired. In this example, your portfolio, if 100% correlated to the S&P 500, would have dropped 9% AND you would have lost the 3% you had originally paid for the put contracts. Thus down 12 when the market was off by 9. Also assume if you didn't get that drawdown in those first 6 months and your bearish tendency caused you to seek another 6-month hedge – and you again placed the same trade to cover the subsequent 6-month period. That's another 3% paid for that supposed insurance protection. Thus, in any given year, the cost of hedging your portfolio is 6%, or $60k on a $1mm portfolio! That's a tidy sum that cannot be ignored should you attempt to do this year in and year out. Of course, options prices change dramatically moment by moment and today's 3% cost could be even more, or less, based on what the market does in the next day or two.

To summarize, hedging is a costly way to protect a portfolio. Usually, we are earning a nice dividend on most of the companies we own, and if we are driving a 3% or 4% dividend yield (or more) each year and then attempt to periodically time the market by buying puts, we'd wipe out all the income and then some in any given year employing such a strategy. This is not a strategy where we believe one can be successful. The market ebbs and flows by 5-15% annually and this is the implied cost of engaging with it! Short term market volatility is the price we pay for long term gains.

Market volatility is a constant. There is always turmoil of some sort in the world, so we best get used to it. We will continue to espouse that our approach to owning high quality companies with sustainable and growing dividends is a proven way to maintain and grow one's net worth. But don't take our word for it – the other day we spotted some interesting comments from one of JP Morgan's strategists that we thought you might find useful.

Dr David Kelly:

So, in late September of 2021, we really can't say we are "due" for a stock market correction because of the length or strength of the stock market run of the last 18 months. However, unlike roulette, there are very important fundamental forces that determine the behavior of markets over time and the weeks ahead will provide significant information on these forces.

- *The pandemic still dominates the investment environment with an average of 2,000 people dying every day from the coronavirus. Thankfully, the number of new cases and hospitalizations appear to have peaked but there is real uncertainty about how fast they will come down from here.*
- *On fiscal policy, Democrats will be scrambling to try to assemble votes to pass both the reconciliation bill and the infrastructure bill, as well as an increase in the debt ceiling and a continuing resolution to keep the government open. In theory, there is a path to do all of this – but it is a narrow path, strewn with land mines, and Wall Street will have every reason to worry about a misstep.*
- *On the economic front, we expect to get generally downbeat economic data although numbers on unemployment claims will likely be examined most closely to see if the labor market is continuing to tighten.*
- *Finally, the Federal Reserve just held its sixth FOMC meeting of the year. Given the uncertainty about the pandemic, fiscal policy, and economic data, it seems likely the Fed is setting up to formally announce a taper at the November meeting and to begin in December with bond purchases falling by $15 billion per month.*

For investors, it is a complicated picture and one which requires balanced judgment. We cannot depend on any simple rules to determine the timing of the next correction. In addition, there is unusually high uncertainty about fundamentals due to the unpredictable nature of the pandemic, high-stakes political negotiations in Washington and the unusual forces both powering and impeding an economic recovery, as we adapt to, or move on from, the pandemic.

What we do know, is that in the long run, valuations matter. This still suggests a relatively short-duration approach to fixed income, an overweight to value stocks within the United States and overseas equities relative to their U.S. counterparts…

We share Dr. Kelly's thoughts because they resonate with Corda's approach to market volatility and corrections, and specifically that, "in the long run, valuations matter." No one can predict when the next market correction will occur, but we can continue to invest in high-quality, sustainable businesses at a good price.

In closing, the key as we move towards 2022 is to expect the unpredictable (volatility) and to keep your laser-like focus on the rewards possible for you when you own high quality companies at the right price. The dividend and interest income will sustain you in the near term and the growth of your principal over time will likely help you achieve financial security. Hedging or buying puts is costly, and assuming markets correct anywhere from 5 – 15% from time to time allows you to consider more about when to be an active buyer than anything else. Use the markets vagaries to your advantage! Wishing all of you the kindest regards as we move forward through these extraordinary times.

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