

Aggressive Hedging with CFDs



Daryl Guppy provides three profit-capturing strategies.

Classic hedging is a do-nothing strategy that gives the appearance of your taking action when in fact you are doing little. The classic hedge is designed as an offset – you lose money on one position and make up the loss with the gain in another, related, position. It's a neutral strategy.

Often the purpose of hedging strategies is to keep a portfolio return matching a benchmark, such as the performance of an index. Neutral strategies use the power of leverage offered by derivative instruments to compensate for losses in less-leveraged stocks and in open positions.

I prefer aggressive hedging. I want to make a profit from my hedge, not treat it as an insurance policy where I surrender the premium irrespective of any claim. That is how options are used in a hedging environment.

I apply hedging strategies only because I am unable, or unwilling, to sell the underlying position. This may be due to investment

constraints, superannuation regulations, inability to go short with the stock, or because it is a genuinely long-term investment. My objective is to use a small amount of cash to deliver substantial returns, which are then injected as new capital into investment positions as the market recovers. Such strategies are used to protect portfolios or investment positions.

There are three types of aggressive hedging:

1. hedging an individual stock;
2. hedging a portfolio;
3. hedging a market.

1. Hedging an individual stock

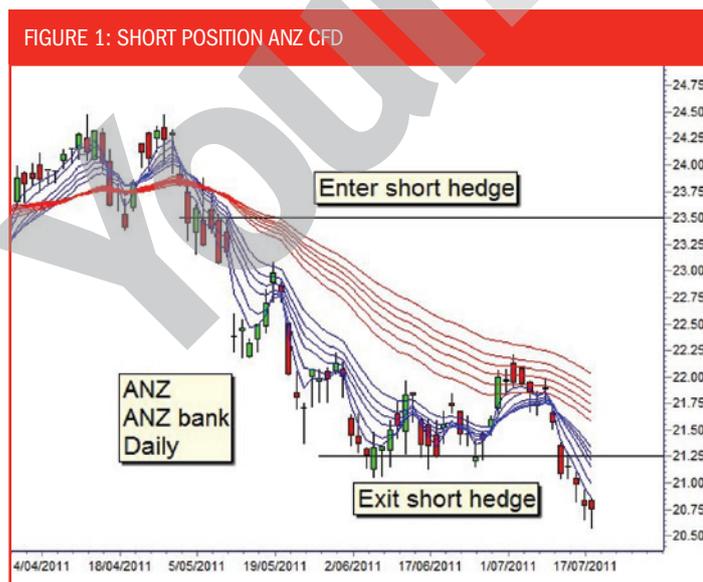
This is the most common aggressive hedge. It is applied when the trader has a long-term open investment position and no desire to sell stock that has provided good income over the years. Typically, such stocks are well-established blue chips such as bank stocks.

The strategy is to trade short in the selected stock. If I am long in ANZ, and the trend turns, then I open a short position with an ANZ CFD (figure 1). The objective is to trade the downtrend and generate enough capital to compensate for the decline in the value of the underlying position. That's hedging 101. An aggressive hedge seeks to generate even more than the loss in the underlying.

This is part of a two-step process. Step one generates a return from the falling stock. Step 2 takes profits from the short trade and re-invests them in the long side underlying position. This is a much more effective method of building long-term investment exposure than the much-touted strategy of buying once a month and dollar-averaging positions.

The calculation starts with an estimate of the degree of decline and the total dollar impact on the underlying position. That is, how much do you expect to lose? This requires an estimate of the downside target for the falling trend. Classic chart pattern analysis and support analysis will locate the target level. For simplicity, in this example we put the expected loss at \$10,000 with a support level near \$21.25.

The calculation continues to determine the return from the short trade required to break even. With an entry at \$23.50 and an exit at \$21.25, what is the CFD position size required to generate \$10,000? Using the IG Markets contract for ANZ, the minimum position size



with a 5 per cent margin, excluding carry costs, is 4,450 or \$5,228. That is the condition for a neutral hedge.

An increase in the cost of the short position to 8,600, for a total cost of \$10,105, increases the profit from the trade to an additional \$9,350. How much capital to put into the aggressive hedge is an individual decision. There are no formulaic rules other than to ensure a reasonable return for the risk taken in the short trade.

The 8,600-size CFD trade is closed at \$21.25 and generates a \$19,350 profit. This new capital can be put into the underlying ANZ stock, adding an additional 910 shares at \$21.25 to the long-term investment.

2. Hedging a portfolio

It's time consuming, and sometimes hair whitening, to aggressively hedge more than one or two core investment stocks. The alternative is to develop a broader hedge that compensates for the expected decline in the value of the total portfolio in a declining market.

The calculation strategy remains the same as for hedging an individual stock, but the detail of the calculation is more complex and difficult. Complex because it requires an estimation of the potential loss in each of the portfolio's stocks. Difficult because it takes real courage to face up to the possibility of significant declines across all, or the bulk of, a portfolio. Events in 2008 should have taught us that such a decline is possible, but it does not make it any easier to sit down and do the calculations.

Developing a full aggressive hedge is difficult and the CFD position size will need to be larger. The hedge is most effectively applied using an Index CFD. This also has higher leverage and potential for a higher dollar return as a result.

When the position is closed out the investor must decide how to allocate profits amongst the individual portfolio holdings. In theory this should be a weighted allocation to each of the stocks in the portfolio. In reality it is often much more effective to allocate to two or three of the better stocks in the portfolio that will generate better rebound and recovery returns.

Short entry

Trading short should be as easy as trading long, but it comes with higher psychological barriers for many investors who are accustomed to making money from long-side positions. The result is that entry into a downtrend tends to be late. This reduces the return, but it also lowers the risk because the downtrend is well established and has a lower probability of reversal.

Entering a short trade uses much the same trend analysis methods as does a long trade. When trading CFDs I prefer to apply a Trend Volatility Line (TVL) to manage the exposure to the trade based on the point of entry. This is not an objective measure of the change in trend. Other classic indicators, including trend line analysis, moving average crossovers and moves below critical support levels, will identify the change in trend.

The TVL is a trade management method designed to manage price volatility within the context of the development of a trend. It sets a stop loss that remains in position for a defined period, and then adjusts the stop loss by a defined amount. Both the duration and amplitude of the stop loss are defined by the changing nature

FIGURE 2: TREND VOLATILITY LINE (TVL)



FIGURE 3: MARKET HEDGING EXAMPLE - INDIA NIFTY 50 INDEX (DAILY)



of the trend (figure 2).

The TVL is based on the Guppy Multiple Moving Average indicator. The TVL captures the inferred behaviour of short-term traders and longer-term investors. It is created with two groups of exponential moving averages. The TVL sets the stop-loss conditions, signalling when it is time to close the short trade and think about going long.

The calculation starts with the breakeven price. This is the entry price plus the amount required to compensate for commissions and slippage. This line is projected to the right and remains as the stop loss value until the value of the breakeven line intersects the value of the 60 period EMA on the GMMA indicator. Once this happens, the TVL line becomes an active manager of the trade position.

The placement of the next stop is calculated by measuring the amplitude of the underlying trend supported by investors. In a short trade, as shown in the attached chart, a line is projected down until it reaches the value of the 30 EMA. From the intersection point a new line is projected to the right. This is the new stop loss.

This stop loss remains valid for a period that is determined by the width of the underlying long-term trend. When this line intersects

the value of the 60 EMA the value of the stop loss is adjusted. In the early stages of a trend the duration of the stop loss's validity is very short. As the trend matures the stop loss remains in position for a longer period. As the trend develops reversal characteristics the duration of the stop loss is reduced.

3. Hedging a market

Hedging by a market is a broader hedging strategy, designed to take the sting out of sovereign risk. It's a challenge to be fully exposed to a domestic market that is moving sideways, or falling, when other international markets are showing much greater growth. Investors can tap into growth by trading individual stocks, or more effectively, by taking CFD index positions in countries where markets are performing strongly. Hedging a market is a type of hedging strategy that does not fall directly into the aggressive strategies discussed above because there is no defined portfolio position that is losing and against which the new hedge position is designed to compensate or protect.

This is a broader hedging strategy that simply acknowledges there are more opportunities in a rising market such as Korea, India or Taiwan than there are in a stagnant market such as Australia. It's an allocation of capital using the reach of the CFD and the leverage

offered by the CFD. The raw index returns show substantial differences that are enhanced with CFD index exposure.

This strategy can be used to generate market index base profits to compensate for the portfolio loss in a domestic portfolio. The purpose is to allocate some profits to the underlying domestic position to take advantage of low but recovering prices to build longer-term investments.

These aggressive hedging strategies are a classic application of one of the 36 strategies of the Chinese – the double-agent ploy. The enemy of all traders are those market forces that attack profits in open positions. Usually the bulk of a portfolio is based on long-side positions, so when markets fall it faces a serious assault. Protection comes from trading the short side while leaving existing long-side positions untouched. We secure assistance from inside the enemy's ranks. The very forces that drive down prices deliver profits that are then used to add to and re-build long-term investment positions and portfolios. 

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