Best Practices in Hedging

Constructing Optimal Custom Hedge Baskets

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Today, we will cover:

1. What is hedging and why should you use it?
2. Custom hedging vs out-of-the-box alternatives
3. Checklist for a custom hedge design

HEDGING IS THE TECHNIQUE OF REDUCING OR TRANSFERRING RISK.

What is Hedging?

Performance	US Large Cap	US Large Cap Hedged 25pct	US Large Cap Hedged 50pct
Jan 3, 2020 to Sep 30, 2020			
Total Return	18.13%	15.00%	11.93%
Annualized Returns	24.16%	19.90%	15.76%
Annualized Volatility	37.12%	23.60%	14.54%
Sharpe	0.65	0.84	1.08
Sortino Ratio	1.00	1.32	1.74
Returns Correlation	0.97	0.95	0.90
Max Drawdown	30.19%	18.75%	10.31%

Source: Omega Point Platform, Wolfe QES US Broad Equity Model.

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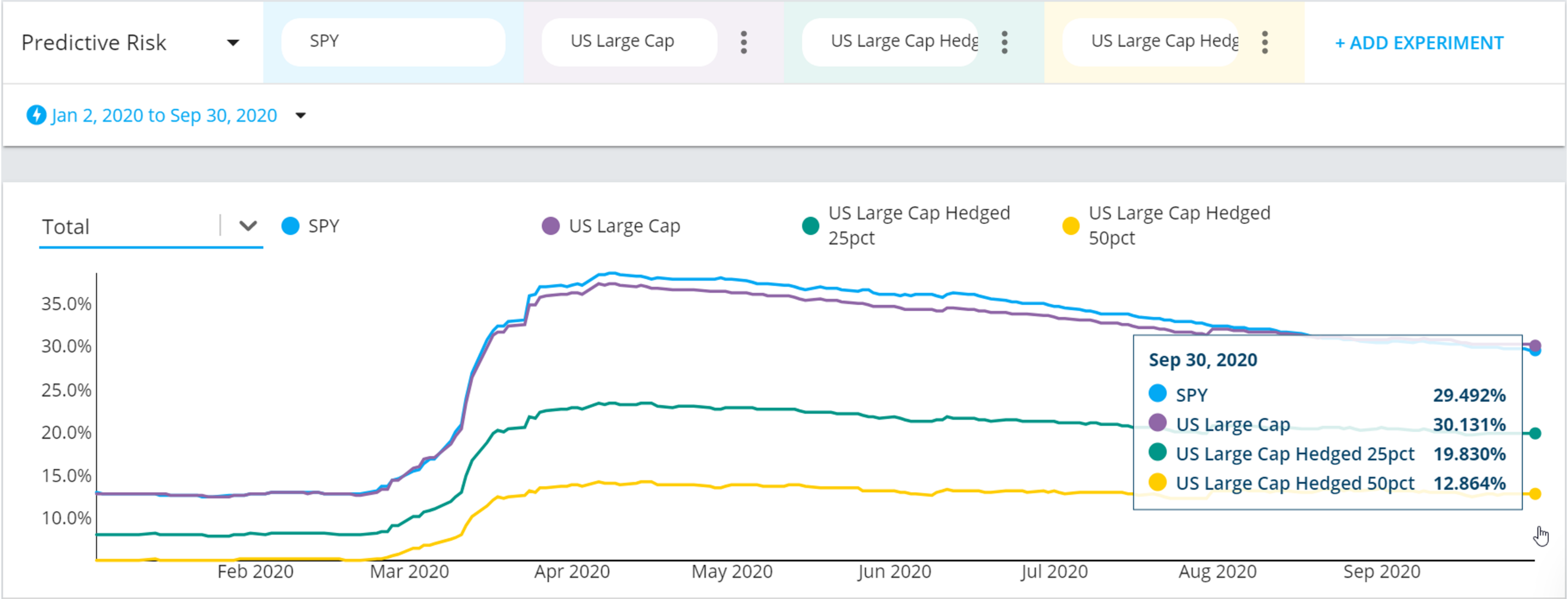

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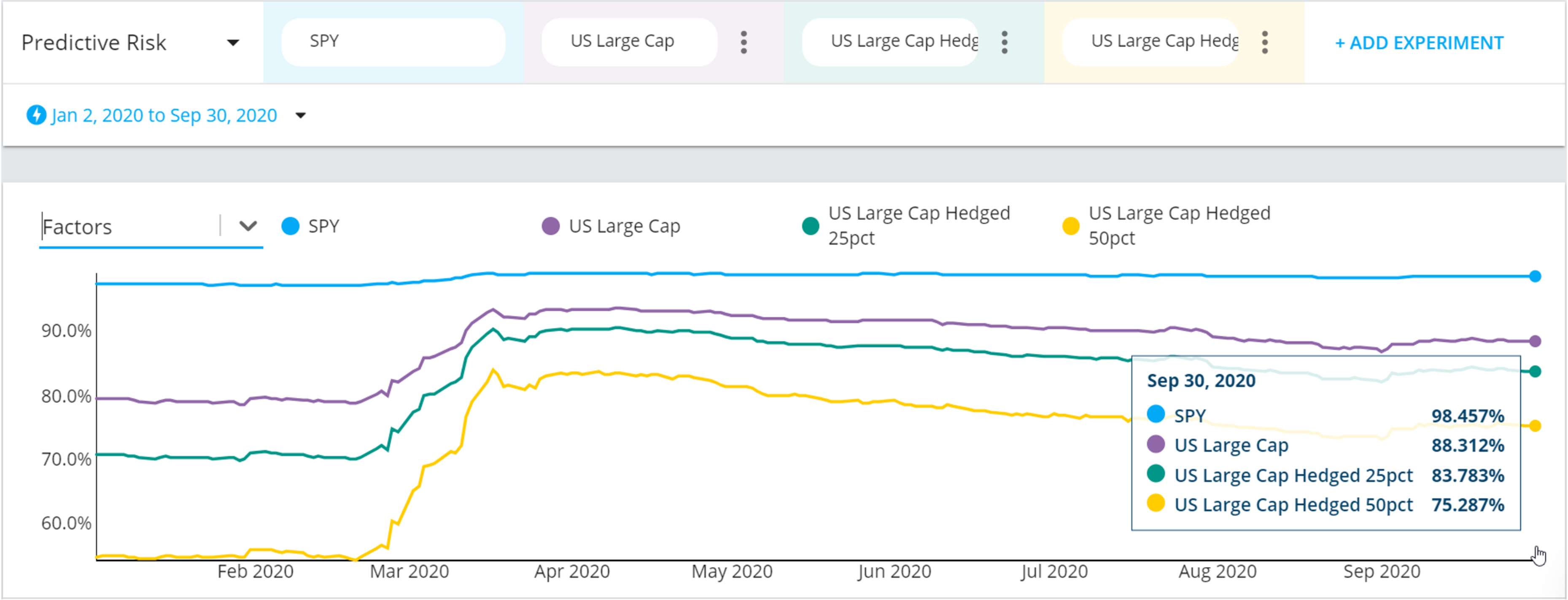

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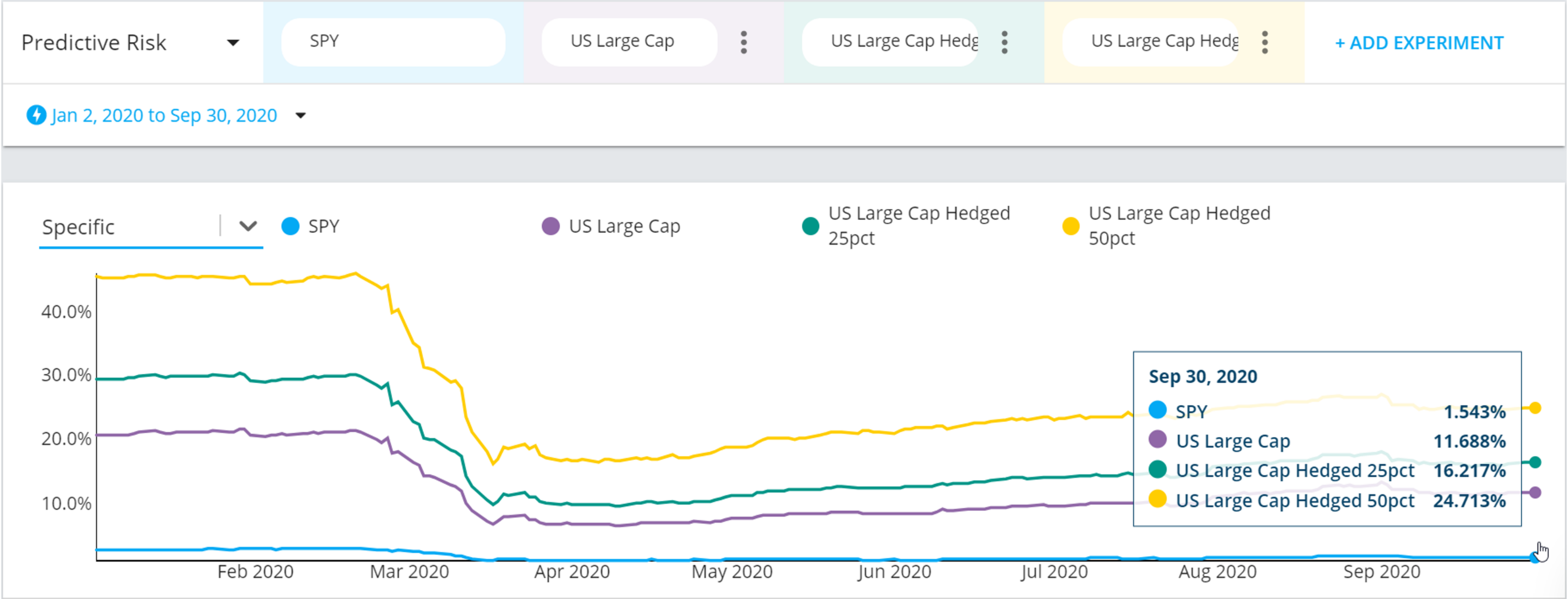

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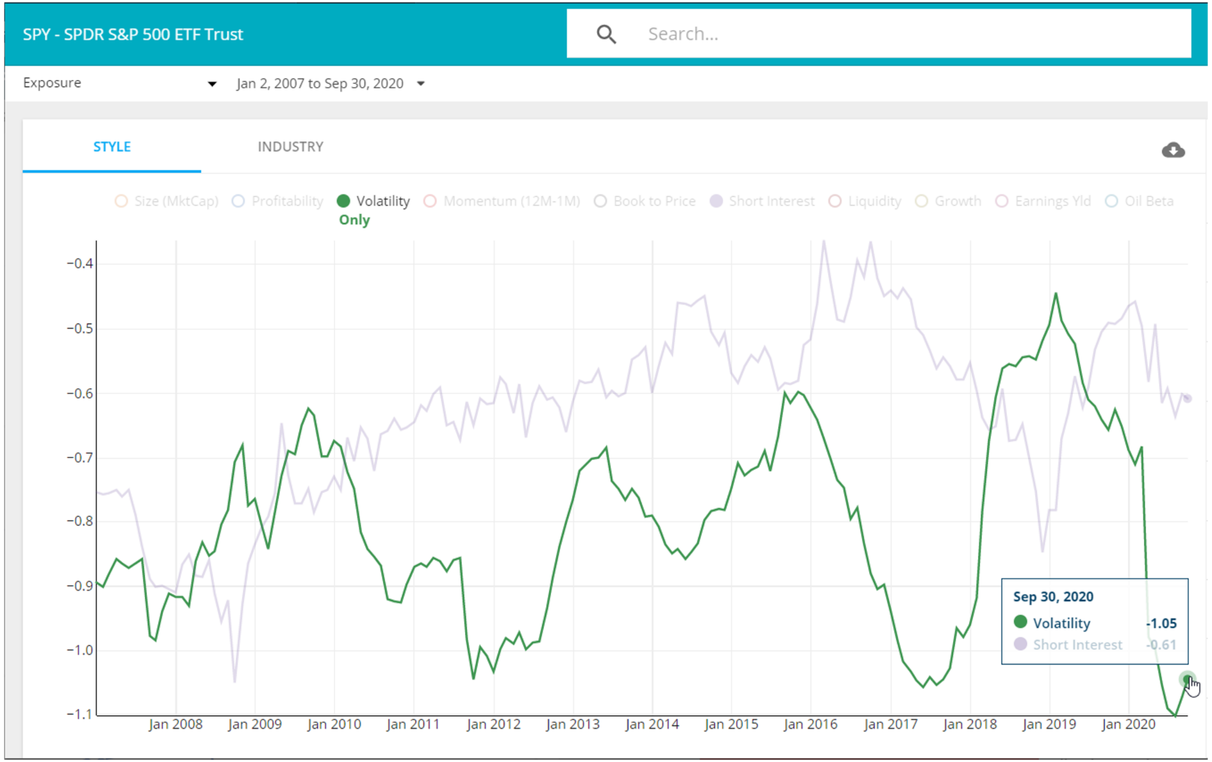
One Size Does Not Fit All



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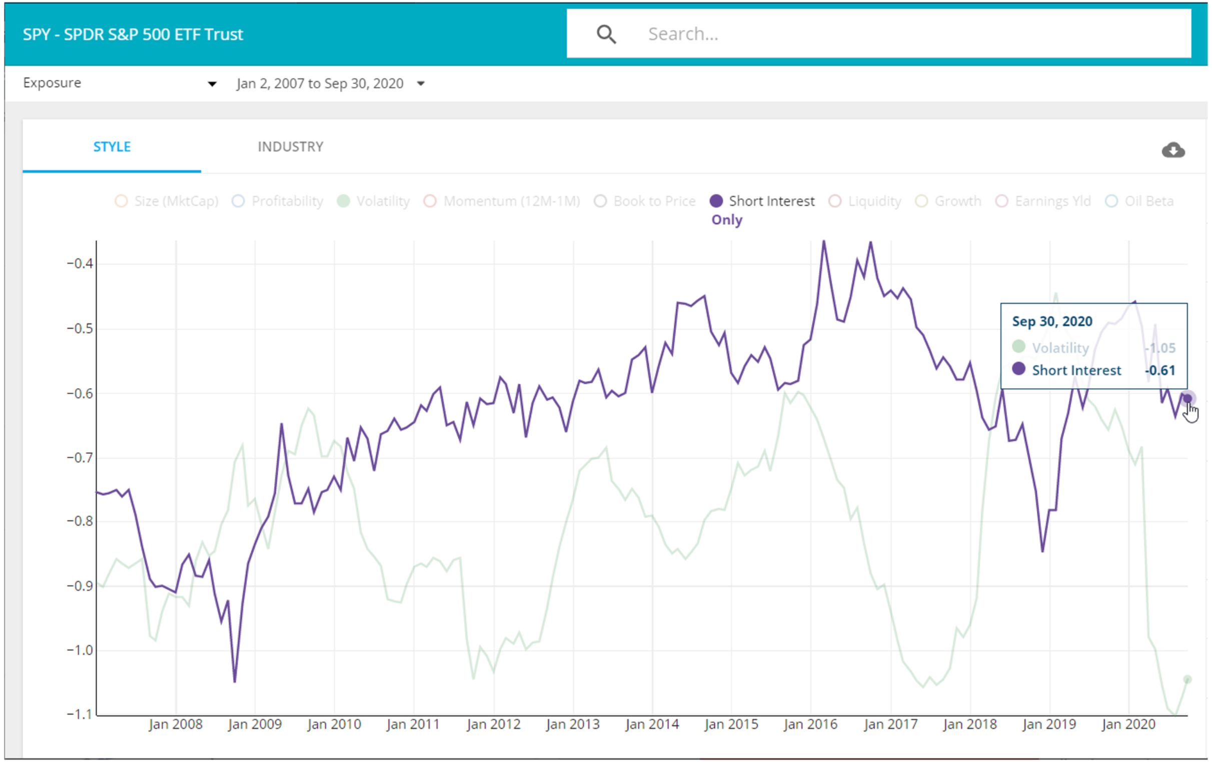
Example: SPY

VOLATILITY

SPY is consistently underexposed to the Volatility factor.

One Size Does Not Fit All

Example: SPY



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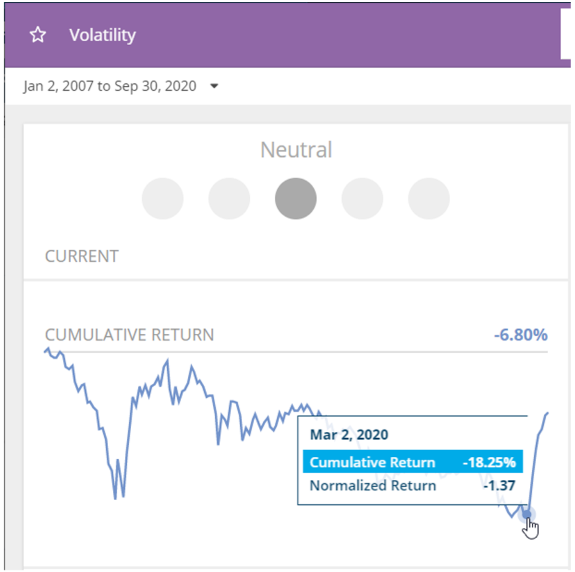

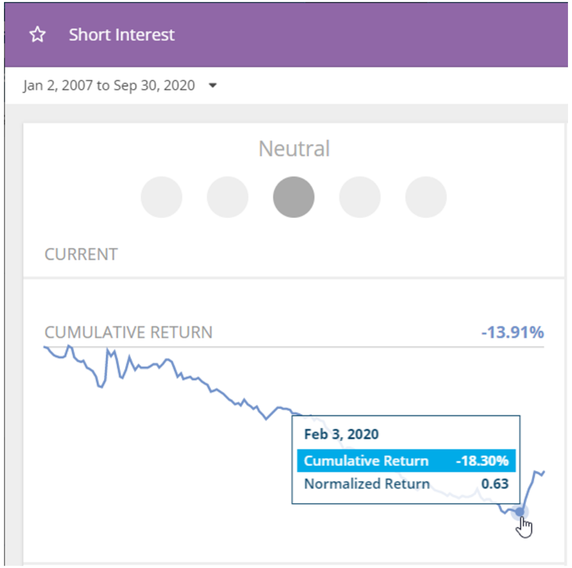

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NEGATIVE PREMIA

Volatility and Short Interest factors have negative premia over time.

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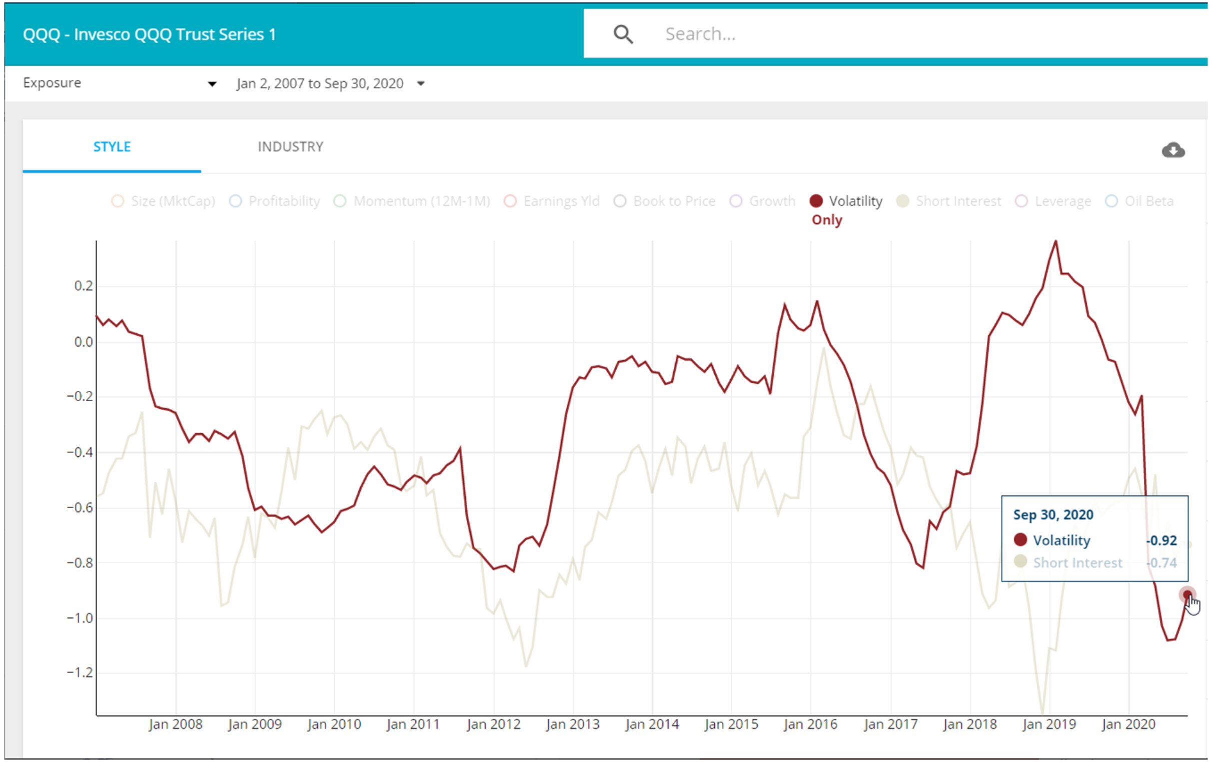

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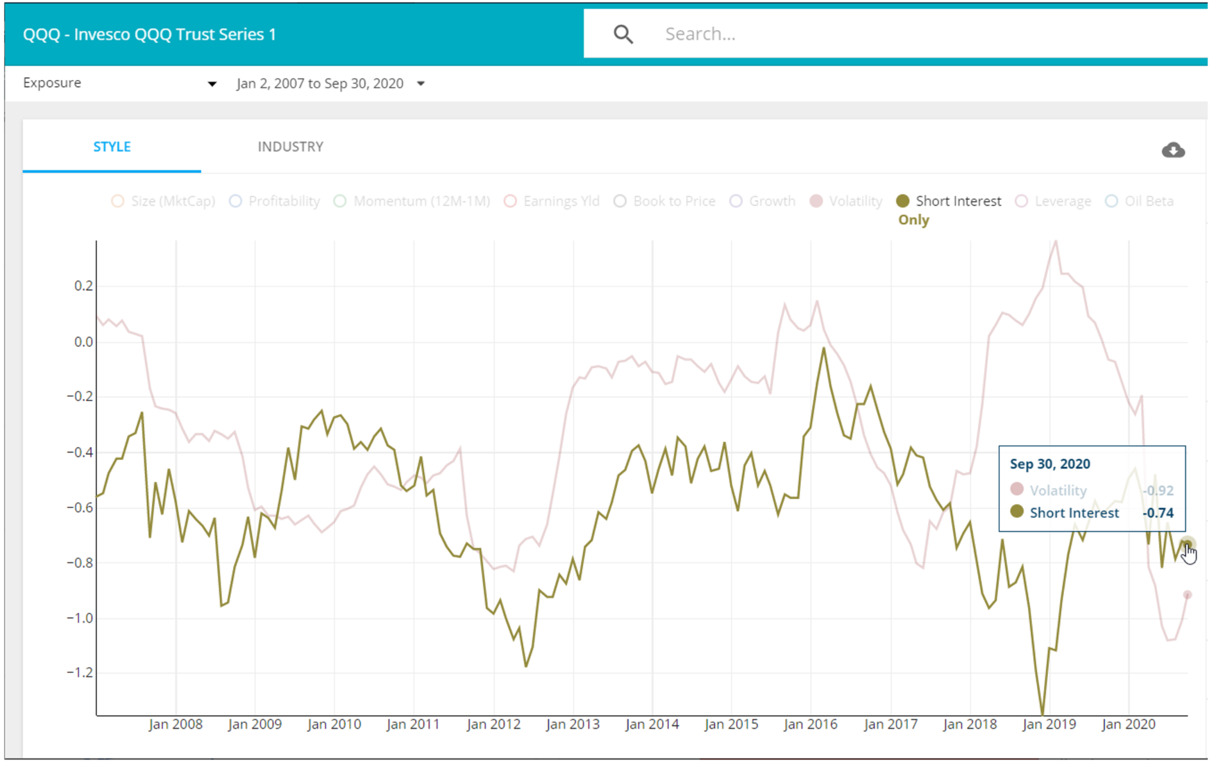

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One Size Does Not Fit All

	ETF Hedging	Custom Hedging
Trade any name	🔴	🟢
Trade any asset class	🔴	🟢
Incorporate ESG mandates	🟡	🟢
Incorporate negative alpha outlook	🟡	🟢
Hedge market risk	🟡	🟢
Optimize hedges based on factor risk	🔴	🟢
Precisely tilt factor exposures	🔴	🟢
Minimize tracking error	🟡	🟢
Avoid what you want to avoid	🔴	🟢
Rebalance any time	🔴	🟢

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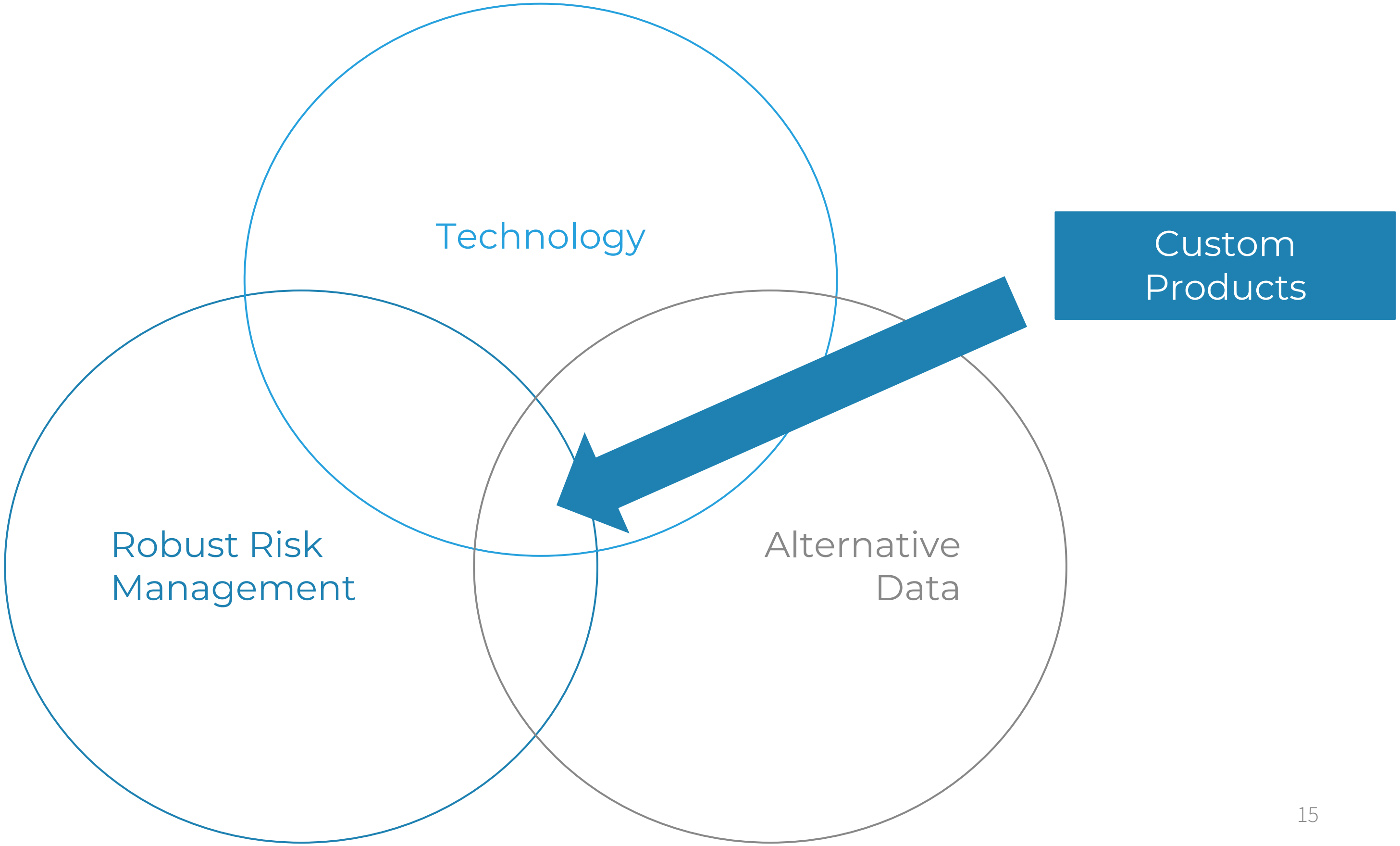


Hedge Construction Checklist

- ❑ Define your **trade universe**
- ❑ Determine optimization **constraints**
- ❑ **Iterate** to gain comfort with the hedge

Hedge Construction Checklist

Trade Universe
Do you have an outlook on your hedge universe?

Outlook	No Outlook
Alpha Incorporate your stock rankings or price targets to identify negative alpha names	**Broad Universe** A larger universe will result in a diversified hedge with less chance of a positive alpha name
Sector / Industry Incorporate industry or sub-industry conviction to avoid large sector bets	No High Stock Specific or Extreme Exposures

Universe Considerations

LIQUIDITY

Higher liquidity is ideal in case the hedge needs to be covered quickly.

HARD TO BORROW

Use short interest data or your broker to provide a list of hard to borrow names to remove from the trade universe.

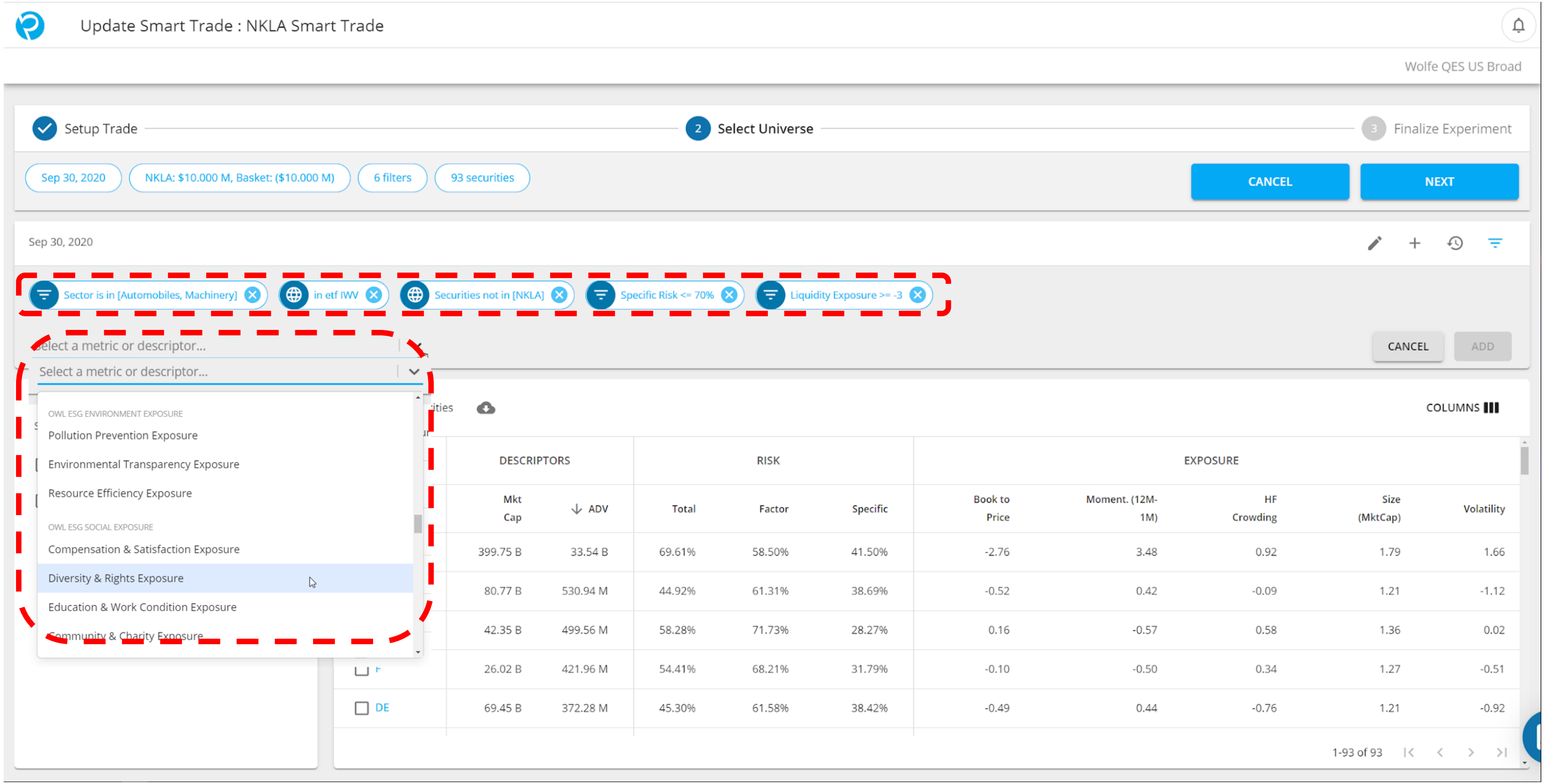
EARNINGS RISK

Remove names with upcoming earnings (within the hedge period) to avoid the “earnings pop”.

SECONDARY LISTINGS

Remove secondary listings so the asset you are hedging doesn’t end up in the hedge.

Hedge Construction Checklist



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Hedge Construction Checklist

Hedge Sizing

To make a pure alpha play…

Consider a full hedge to dampen factor risk and boost your alpha

To have an insurance policy…

Consider a partial hedge. Your conviction should inform hedge size

Asset Constraints

More is better

More names in the hedge create a lower chance of an idiosyncratic event driving hedge performance

Avoid high concentration

A single name should not drive the hedge (unless it is a pairs trade)

Market impact

Positions relative to ADV should not exceed 5-10%

Factor Constraints

Neutralize core portfolio factor bets

Target risky portfolio factor exposures to create a net neutral factor portfolio and let your alpha shine

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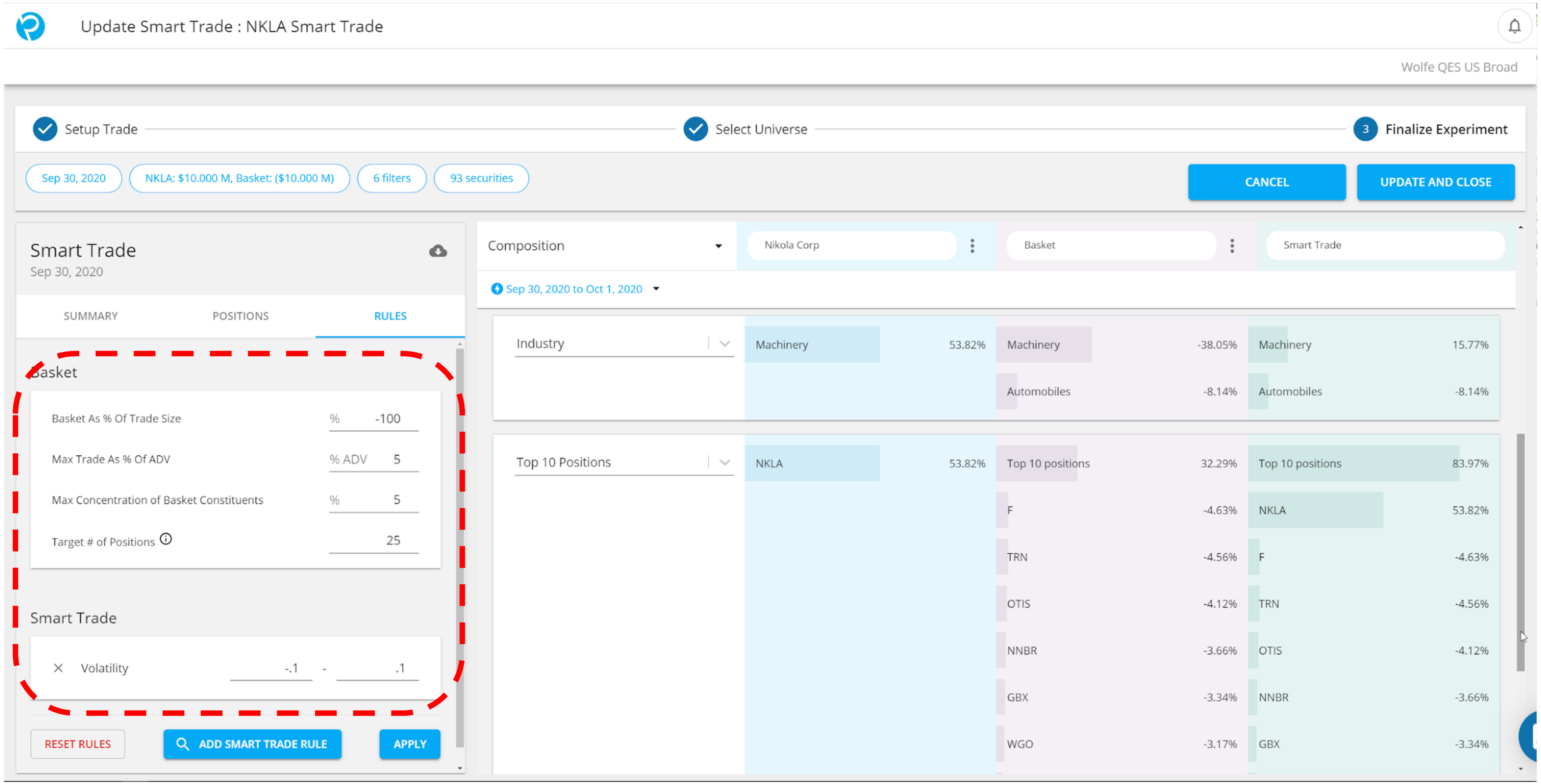

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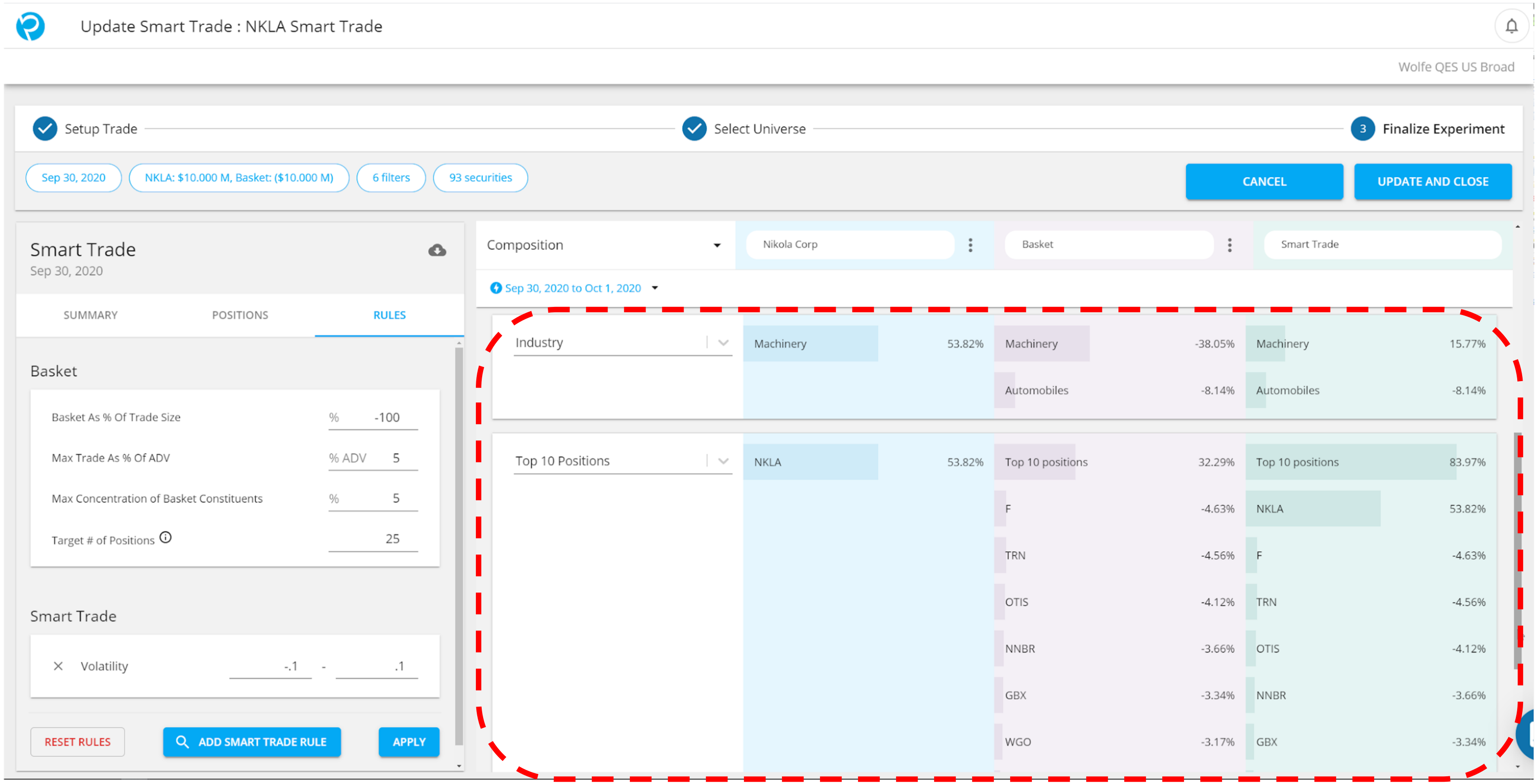

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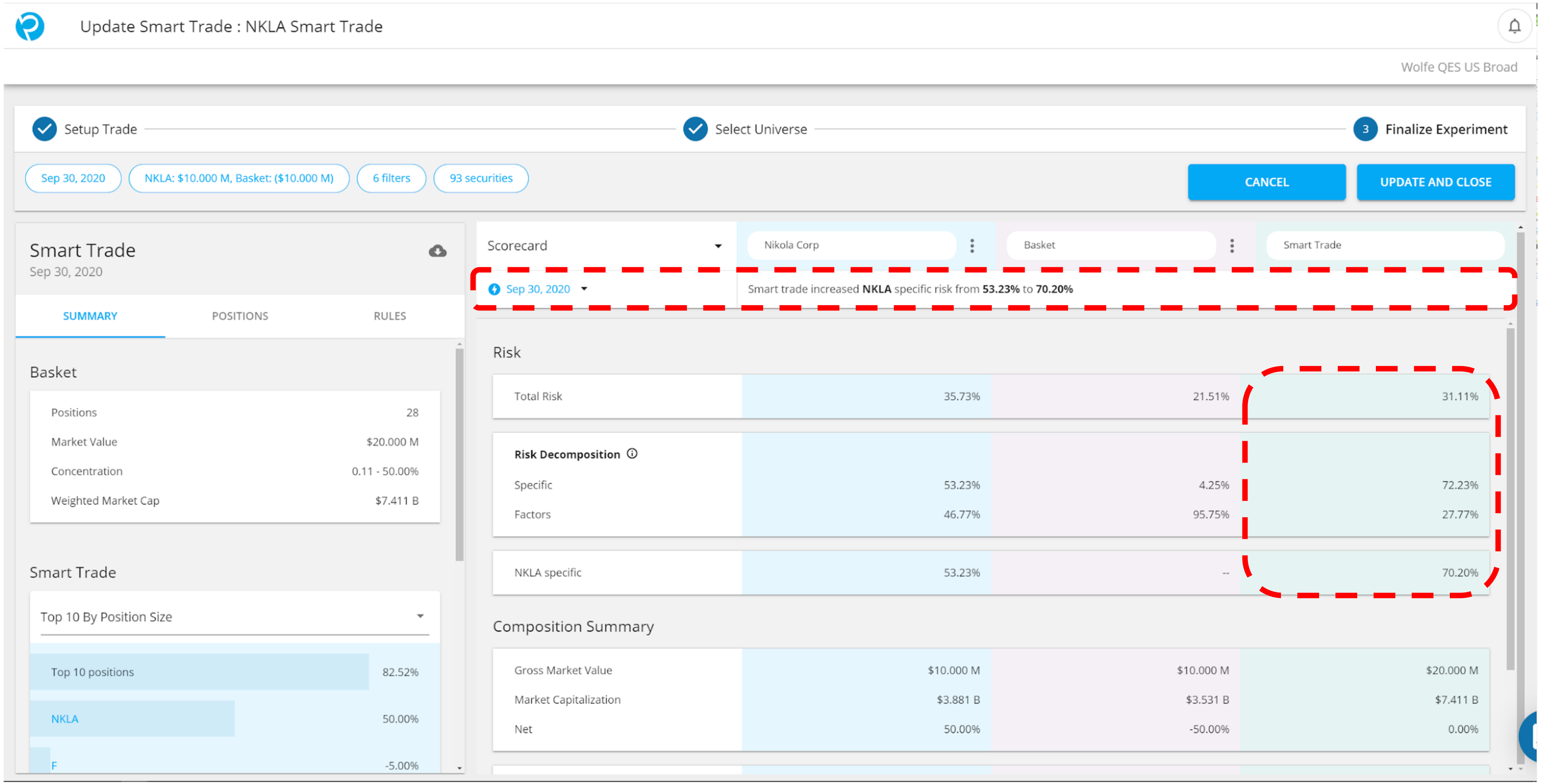

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Once your hedge is built...

It's time to iterate and backtest!

Upcoming Webinar

Join us next week for Part 2 in our webcast series: **Simulation and Testing of Your Hedging Strategies**

Learn best practices for backtesting hedges and evaluating custom hedges relative to alternative out-of-the-box options.

Registration Link

Email: sales@ompnt.com

Sign up for our weekly e-newsletter
Factor Spotlight
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