



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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What is Hedging?

Predictive Risk ▼

SPY

US Large Cap

US Large Cap Hedge

US Large Cap Hedge

+ ADD EXPERIMENT

⚡ Jan 2, 2020 to Sep 30, 2020 ▼

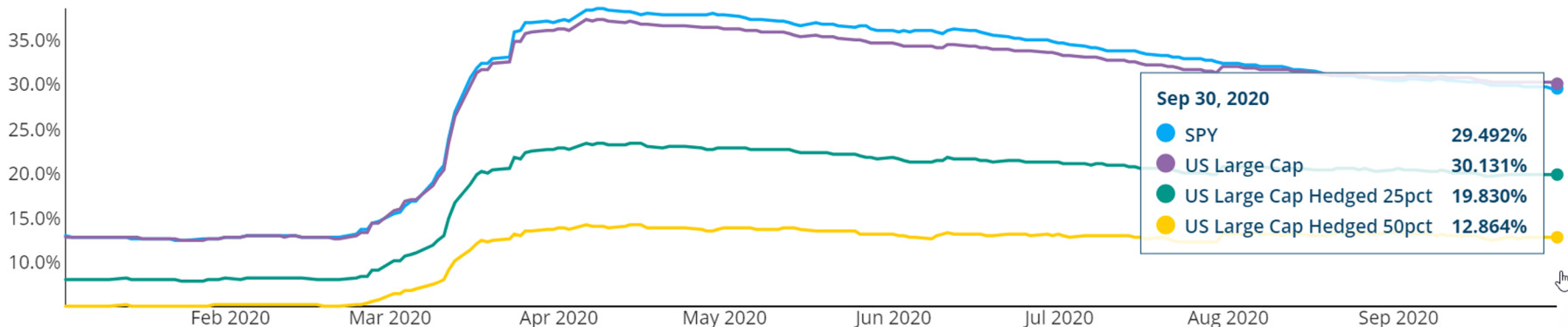
Total

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US Large Cap

US Large Cap Hedged
25pct

US Large Cap Hedged
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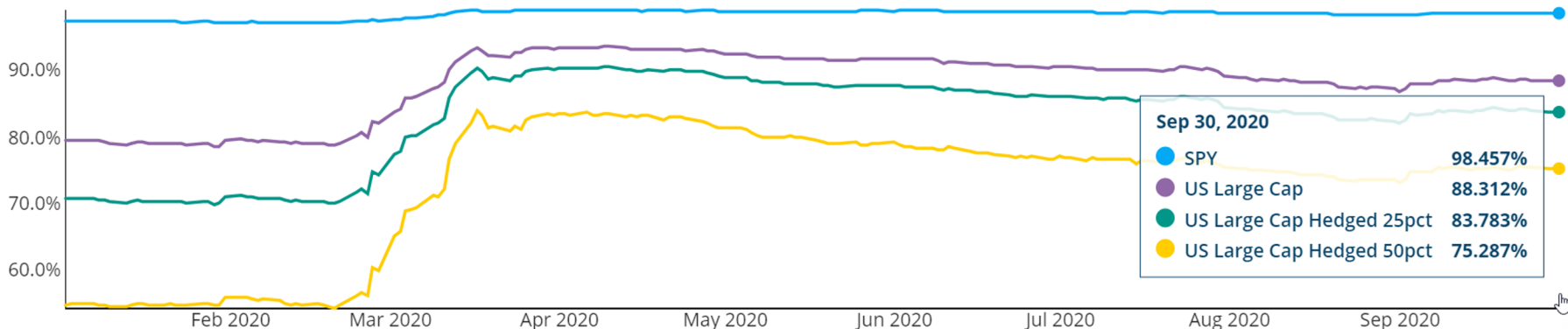
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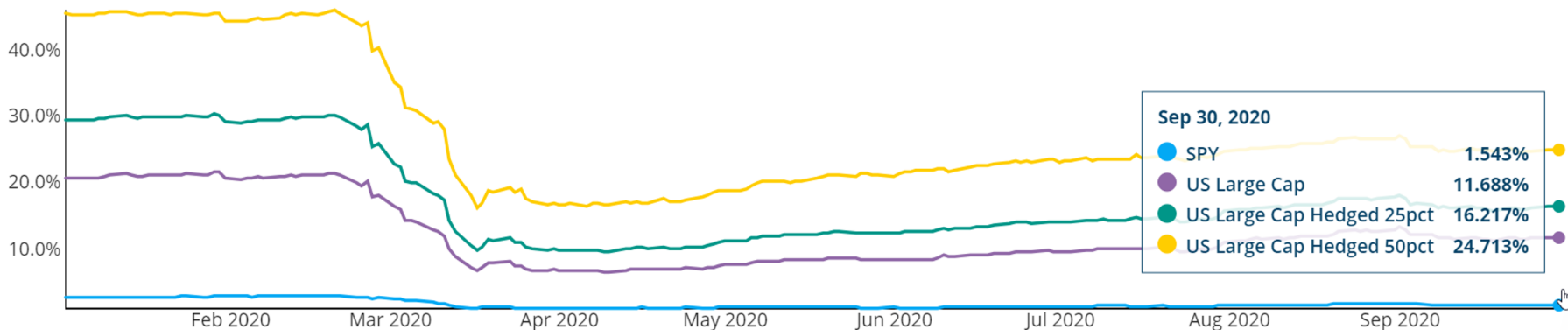
Specific | ▼

● SPY

● US Large Cap

● US Large Cap Hedged
25pct

● US Large Cap Hedged
50pct



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



One Size Does Not Fit All

Example: SPY

SPY - SPDR S&P 500 ETF Trust

Search...

Exposure

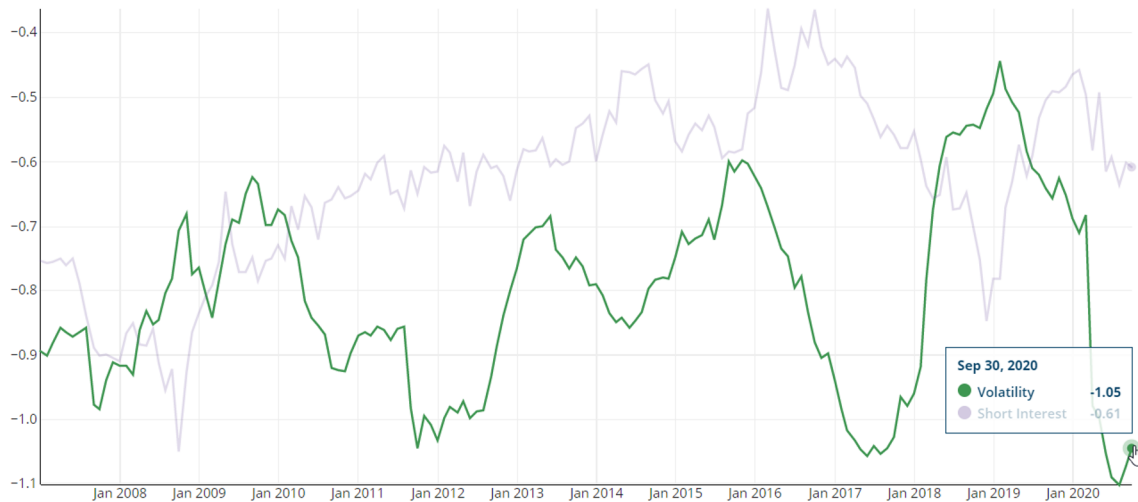
Jan 2, 2007 to Sep 30, 2020

STYLE

INDUSTRY

Size (MktCap) Profitability Volatility Momentum (12M-1M) Book to Price Short Interest Liquidity Growth Earnings Yld Oil Beta

Only



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

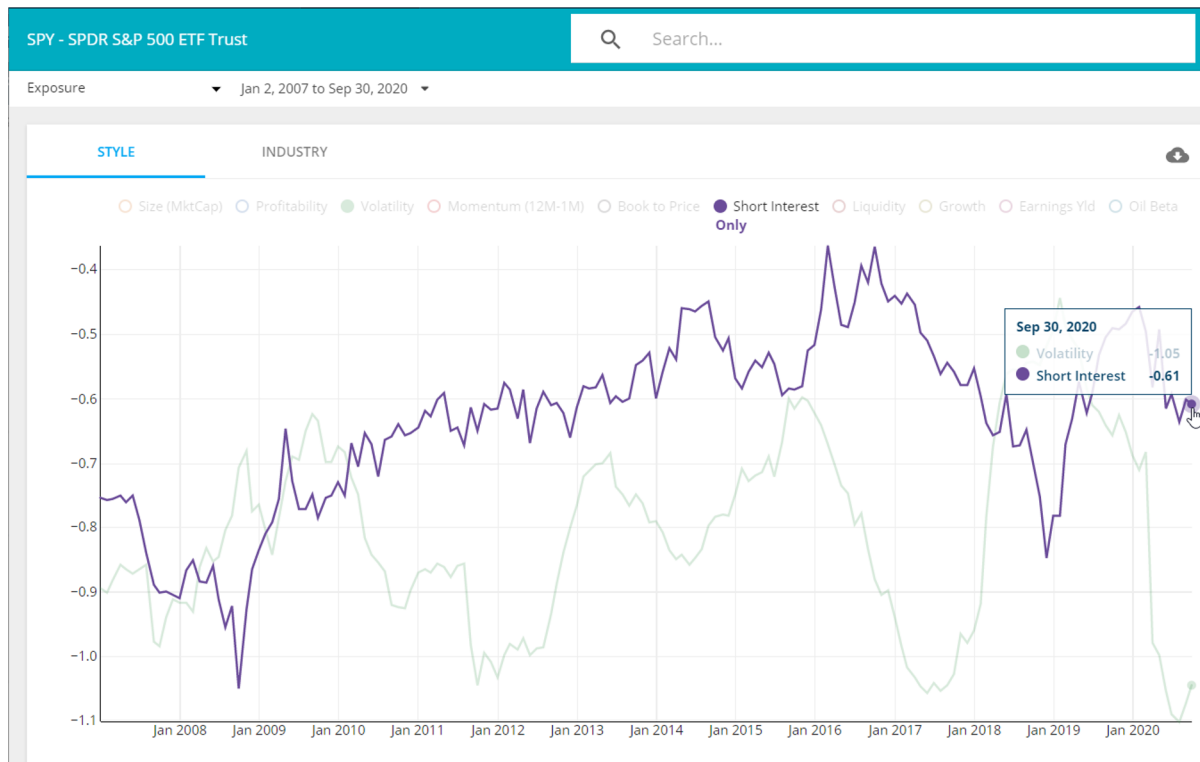
VOLATILITY

SPY is consistently underexposed to the Volatility factor.



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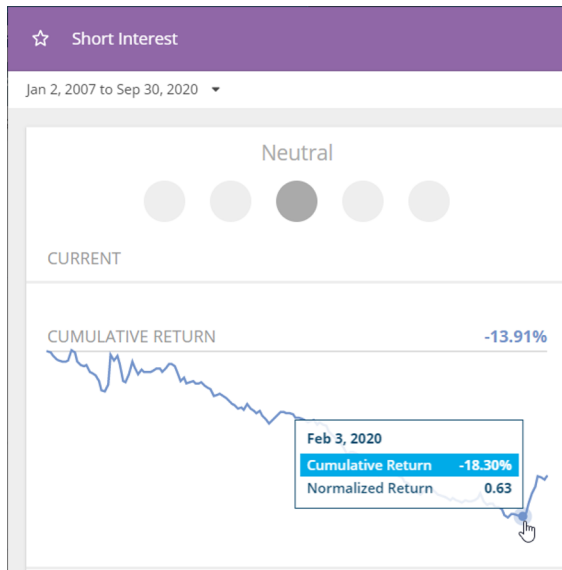
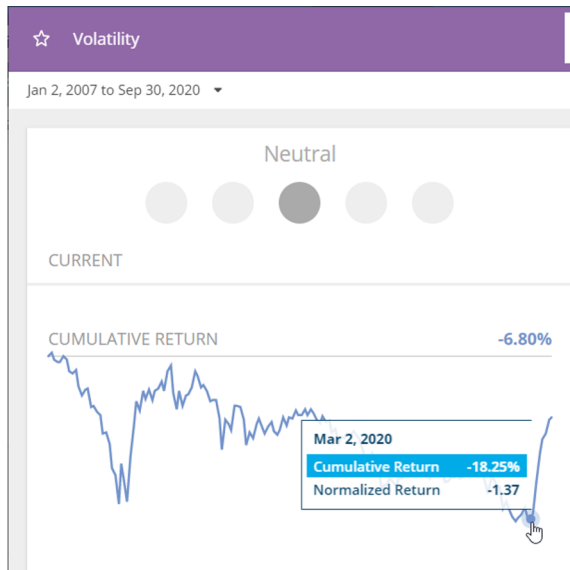
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NEGATIVE PREMIA

Volatility and Short Interest factors have negative premia over time.



One Size Does Not Fit All

Example: QQQ

QQQ - Invesco QQQ Trust Series 1

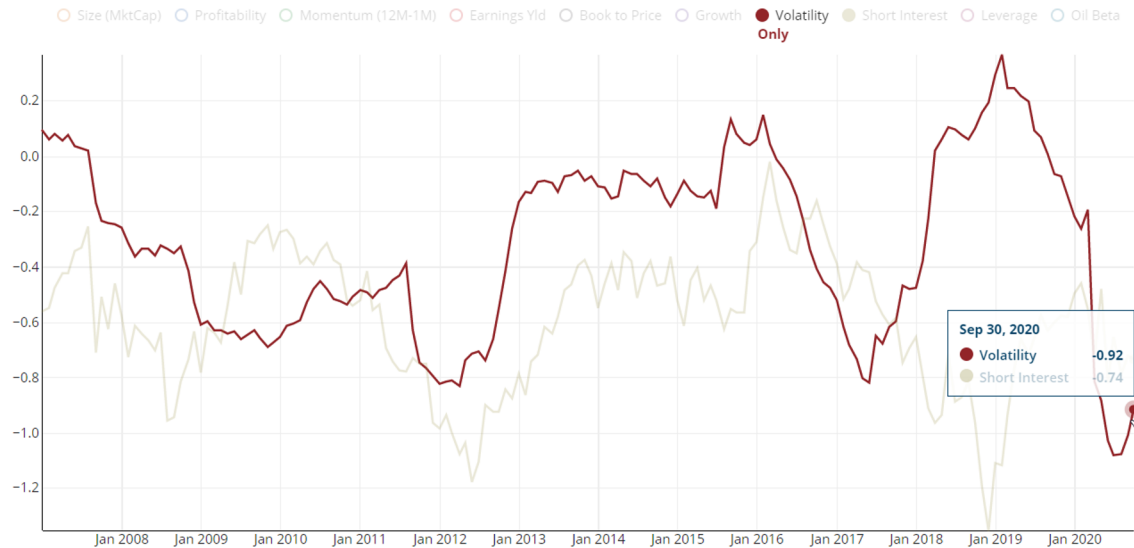
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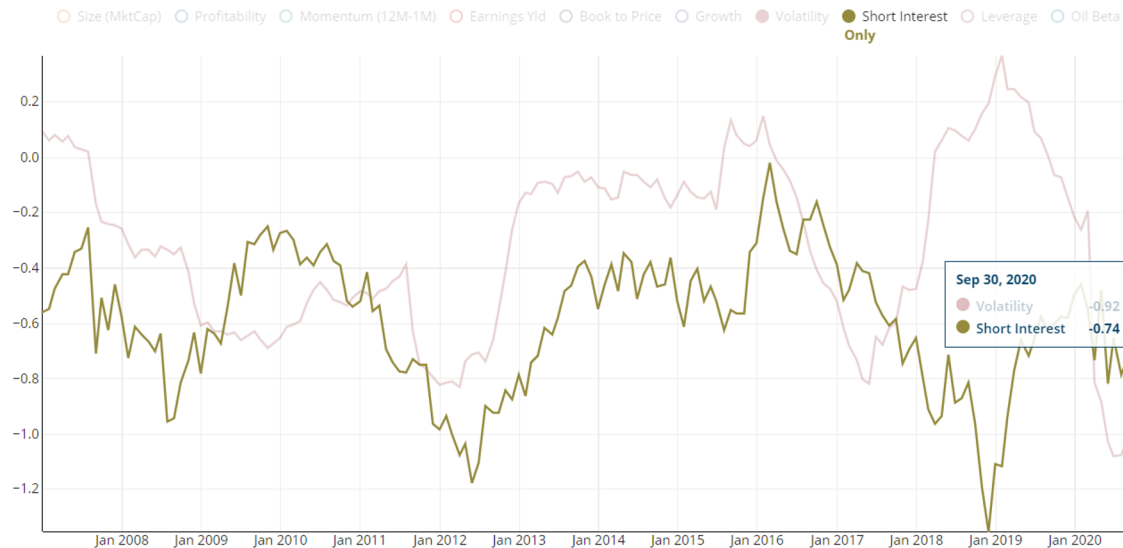
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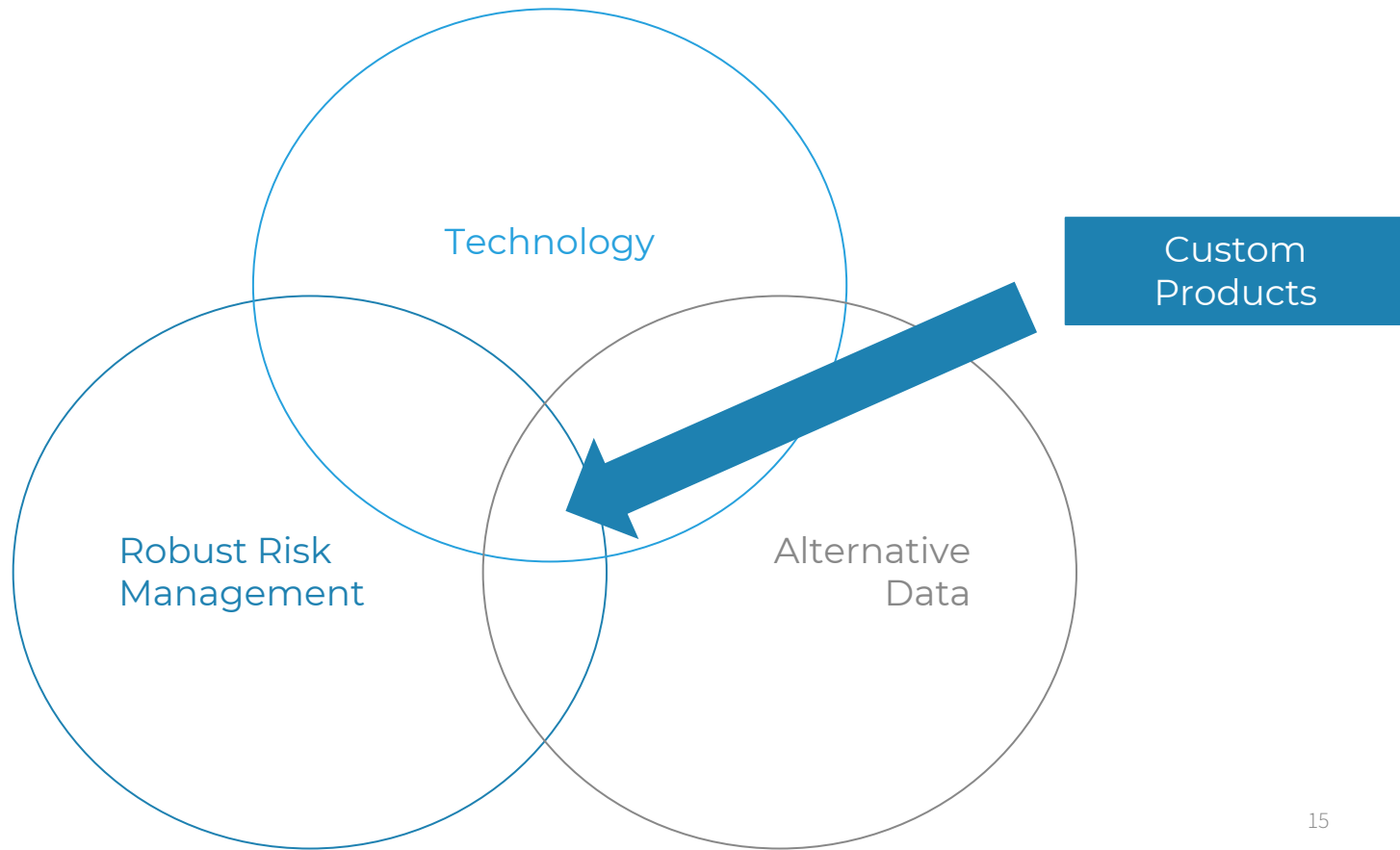
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One Size Does Not Fit All

	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		

One Size Does Not Fit All



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



Alpha

Incorporate your stock rankings or price targets to identify negative alpha names

Sector / Industry

Incorporate industry or sub-industry conviction to avoid large sector bets

No Outlook



Broad Universe

A larger universe will result in a diversified hedge with less chance of a positive alpha name

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

 Update Smart Trade : NKLA Smart Trade

Wolfe QES US Broad

✓ Setup Trade

2 Select Universe

3 Finalize Experiment

Sep 30, 2020NKLA: \$10.000 M, Basket: (\$10.000 M)6 filters93 securities

CANCELNEXT

Sep 30, 2020

Sector is in [Automobiles, Machinery]in etf IWWSecurities not in [NKLA]Specific Risk <= 70%Liquidity Exposure >= -3

Select a metric or descriptor...

OWL ESG ENVIRONMENT EXPOSURE

Pollution Prevention Exposure

Environmental Transparency Exposure

Resource Efficiency Exposure

OWL ESG SOCIAL EXPOSURE

Compensation & Satisfaction Exposure

Diversity & Rights Exposure

Education & Work Condition Exposure

Community & Charity Exposure

CANCELADD

DESCRIPTORS		RISK			EXPOSURE				
Mkt Cap	↓ ADV	Total	Factor	Specific	Book to Price	Moment. (12M-1M)	HF Crowding	Size (MktCap)	Volatility
399.75 B	33.54 B	69.61%	58.50%	41.50%	-2.76	3.48	0.92	1.79	1.66
80.77 B	530.94 M	44.92%	61.31%	38.69%	-0.52	0.42	-0.09	1.21	-1.12
42.35 B	499.56 M	58.28%	71.73%	28.27%	0.16	-0.57	0.58	1.36	0.02
26.02 B	421.96 M	54.41%	68.21%	31.79%	-0.10	-0.50	0.34	1.27	-0.51
69.45 B	372.28 M	45.30%	61.58%	38.42%	-0.49	0.44	-0.76	1.21	-0.92

1-93 of 93

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

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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✓ Select Universe

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Sep 30, 2020 NKLA: \$10.000 M, Basket: (\$10.000 M) 6 filters 93 securities

CANCEL UPDATE AND CLOSE

Smart Trade

Sep 30, 2020

SUMMARY POSITIONS RULES

Basket

Basket As % Of Trade Size % -100

Max Trade As % Of ADV % ADV 5

Max Concentration of Basket Constituents % 5

Target # of Positions ⓘ 25

Smart Trade

X Volatility -1 - .1

RESET RULES ADD SMART TRADE RULE APPLY

Composition

Nikola Corp

Basket

Smart Trade

Sep 30, 2020 to Oct 1, 2020

Industry Machinery 53.82%

Machinery -38.05%

Automobiles -8.14%

Machinery 15.77%

Automobiles -8.14%

Top 10 Positions NKLA 53.82%

Top 10 positions 32.29%

Top 10 positions 83.97%

F -4.63%

NKLA 53.82%

TRN -4.56%

F -4.63%

OTIS -4.12%

TRN -4.56%

NNBR -3.66%

OTIS -4.12%

GBX -3.34%


NNBR -3.66%

WGO -3.17%

GBX -3.34%

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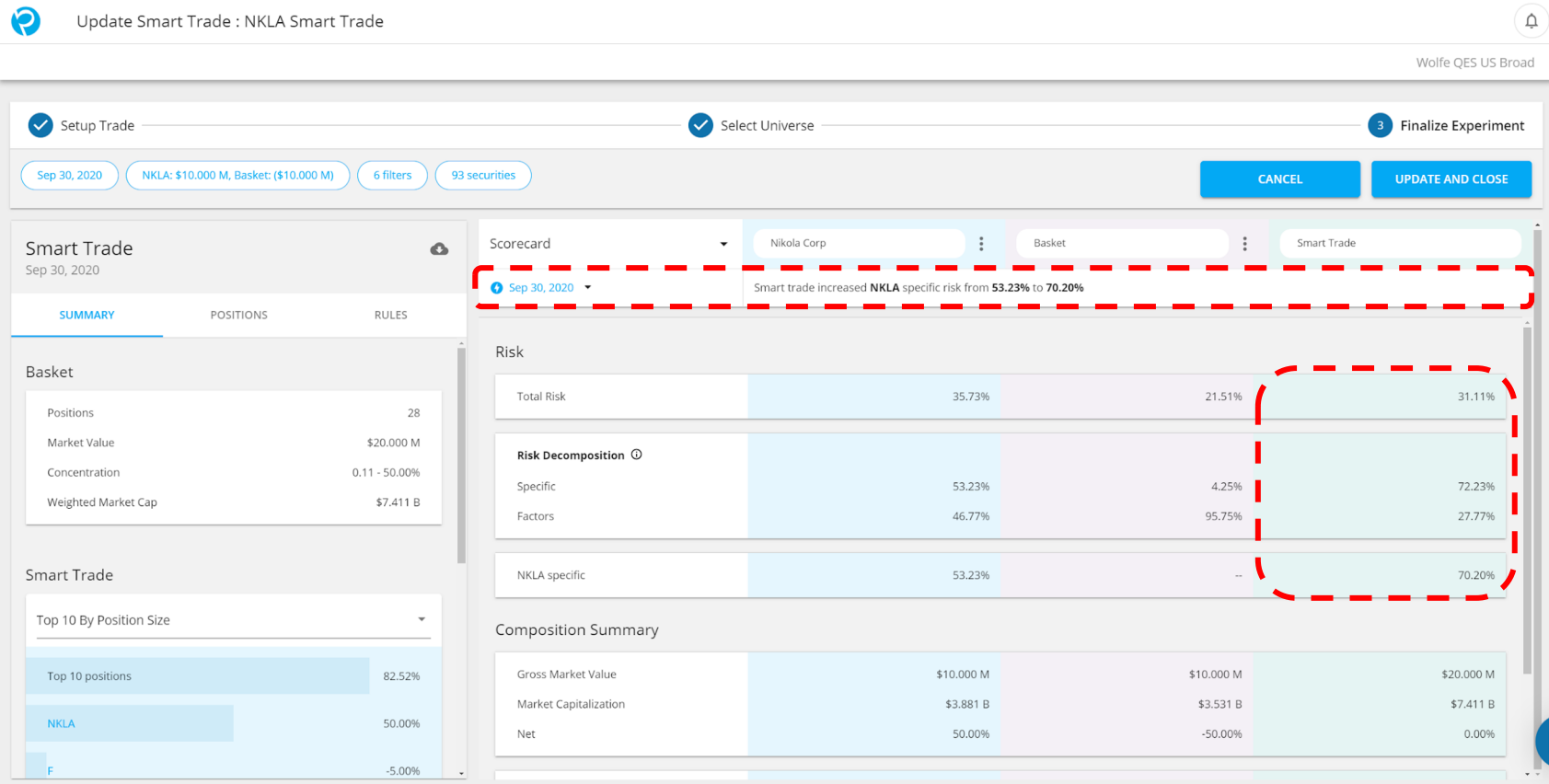
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Hedge Construction Checklist



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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](#)



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