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ATLANTIC CAPITAL MARKETS

How to Protect your wealth in a Financial Crash

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How to Hedge Effectively & Other trading Strategies.

Since the initial Covid impact the markets have recovered steadily, that is up until the recent news on the African variant, now this news could come and go and the markets continue on their way. However, the market's never like uncertainty and now could be a good time to consider protecting your long term portfolio against short term uncertainty. Most investors will simply try and hold through, some will try to buy, and the more savvy will hedge. Most short-term market drops that you are seeing will tend to even out over the longer term, but it isn't the long term that's the problem it is the short term you want to protect against.

So, what is a hedge?

Hedging is an effective investment mechanism that aims to cancel or reduce the risks involved in one form of investment with a counter form of investment. A hedge is a position opened in one financial instrument with the main aim of offsetting exposure to price fluctuations in an opposite position in another asset.

Hedging is nothing new, why do you think hedge funds have that name.

The term "hedge fund" originated from the paired long and short positions that these funds use to hedge market risk. Over time, the types and nature of the hedging concepts expanded and became more complex as did the different types of investment vehicles. Today, hedge funds engage in a diverse range of markets and strategies and employ a wide variety of financial instruments and risk management techniques.

However, the techniques used can be seen to be over complicated and for the purpose of this report we are going to look at simply hedging stock to stock.

Hedging With a CFD

Hedging with a CFD can be seen as a form of insurance, especially for your portfolio and is the easiest and most accessible way for investors to cover positions.

For instance, the market is going to crash, and your shares are going to drop, there is nothing you can do to stop that but if you do not want to sell out in the short term. Hedging with a CFD will reduce the overall impact to your portfolio. It is not necessarily about how much profit you can make but more about covering your losses until the market comes to rest. You then simply close out your shorts, bank the profits and wait for the shares to recover. It is important to note that your physical shareholdings still need to recover but at least you have banked a decent profit on the downside.

Simplified stock hedging

So, as you review your portfolio, and let's hope it is well diversified! and in the long term these business' are sound, paying a good dividend and you don't want to respond with a knee jerk reaction and sell out, however a short term crisis is brewing up(let's say Coronavirus). In these situations, short term fear will overcome any long-term rational view. This is a prime situation to protect your capital and portfolio.

Example:

Using a CFD to short sell a stock you hold long term in your portfolio to offset a share purchase.

let's say an investor who holds Barclays shares for the long term may want to open a short CFD position to hedge the long exposure. In this way, should the price of Barclays shares go down. The investor doesn't suffer as the losses incurred in the share's will be matched by the profit made in the CFD short.

Short positions can only be taken using derivatives and it is unable to be used with traditional share buying.

Why use CFD's

Contracts for Difference are one of the most popular hedging tools among investors and traders alike.

Key Benefits include:-

· The ease of being able to open positions and close positions

· The lower margin needed for a position (typically only a 20% deposit is required for a position)

· They tend to mirror market prices

· No stamp duty applied

· The ability to simply "Go Short"

Other Hedging Trading Strategies

Hedging isn't the only practical use for investors, there are several other key trading strategies worth mentioning.

Long-Short Equity

This popular hedge fund strategy involves buying certain shares (going long) and selling others (going short).

Most investors rely on a rising market to make money. By using this strategy an investor has the potential to make money in any market conditions. When an investor has the same exposure on both the long and short side, they are said to be "hedged". That's how hedge funds got their name.

By having a combination of long and short positions, an investor can mitigate some of the market risk and aim for absolute profits, not just profits handed to you by the market.

Most institutional investors (such as hedge funds) don't hold an equal amount of long and short positions – they take a market view – bullish or bearish. But they also don't tend to leave themselves completely exposed to one side of the market or the other either. For example, they might be 60% long and 40% short – meaning they have a bullish bias on the market. So, if they had a £100,000 portfolio, they could have £60,000 of longs (buys) and £40,000 of sells (shorts). The 40% short exposure would be made up of stocks they think are overvalued and would provide their portfolio with a partial hedge, seeking to protect them from a falling market.

An investor may choose to take profits on some positions during a volatile period to bank some gains. This year we have had some sharp falls, and this would give an investor an opportunity to bank profits on the short side.

Ordinary shares don't work too well when employing a long-short strategy as it's not easy to go short. However, with CFDs you can just as easily go long or short.

Pairs Trading

The aim of Pairs Trading is to match or "pair" two trading instruments that are highly correlated (that have historically moved together).

Usually that means finding two businesses in the same industry such as Lloyds and Barclays or BP and Shell.

When you look at the price charts of two similar businesses, you can see that most of the time their shares move up and down at the same time.

Traders are looking to take advantage of periods of divergence between the two shares. When these divergences occur, a trader takes a long position in the underperformer and a short position in the overachiever. The monetary value of the position sizes should be the same, rather than number of shares. If the pair reverts to its normal trend, the positions are then closed, and an overall profit is made.

Historical studies covering three decades of UK data found that Pairs Trading outperformed the market both in returns and risk levels over the full sample period.

Pairs trading strategy relies on "reversion to the mean". In other words, that things will return to normal and the historical relationship will hold. One feature of the strategy is that it's market neutral (because there is a long and short position of the same size), meaning the direction of the overall market is not a factor.

Pairs trading with CFDs can be executed easily. Because the gains from pairs trading can be relatively small in percentage terms, traders usually amplify the returns by using leverage.

About Atlantic Capital Markets

We are a multi-Asset brokers offering clients the ability to buy the shares either in a traditional fashion with standard shares or taking advantage of leverage and purchase via a CFD.

Call us on 01872 229 000.