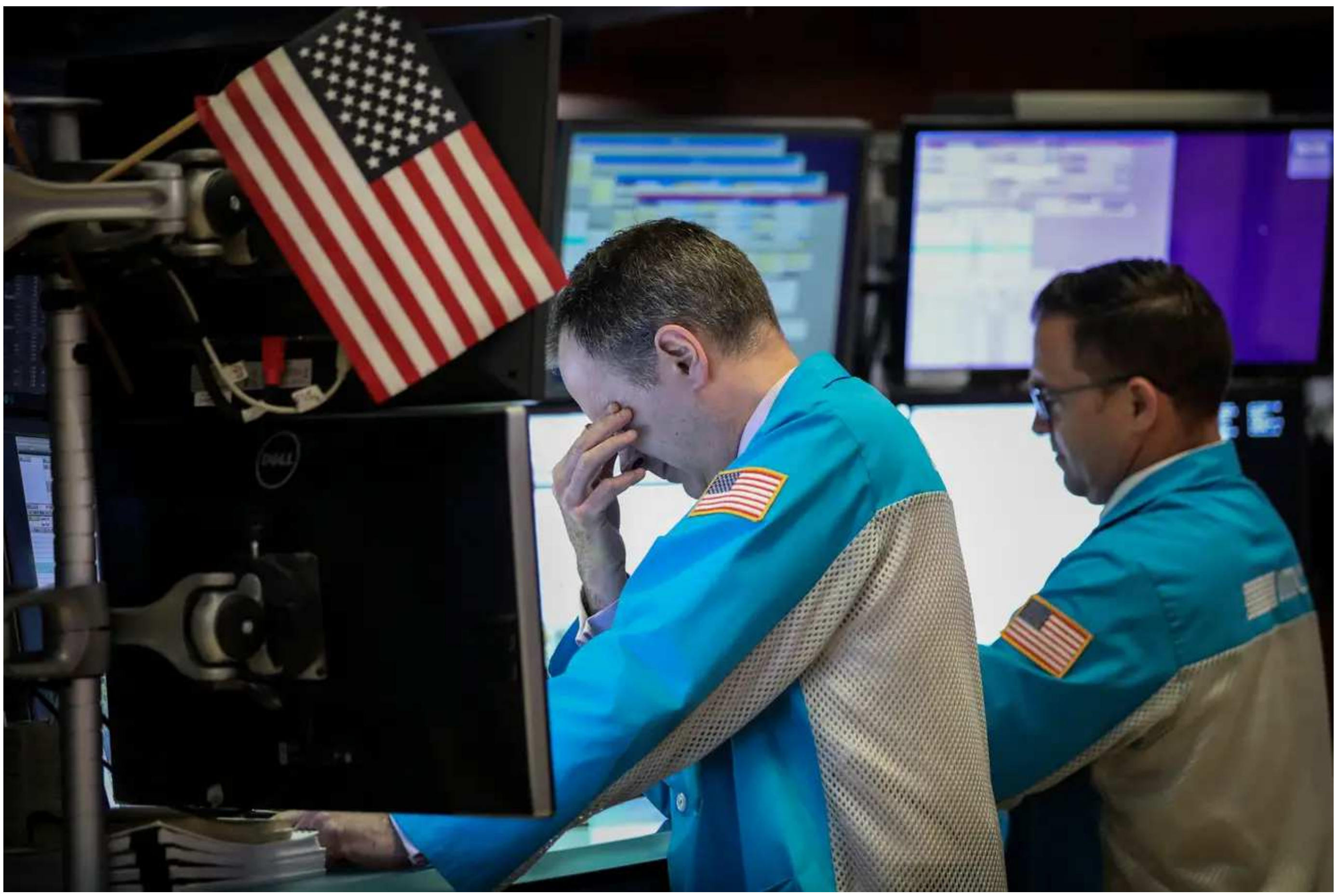
MARKETS

Now is probably a good time to hedge against downside risk in the stock market. Here are 4 ways you can protect your portfolio — including 2 that are historically cheap.

William Edwards Mar 31, 2024, 2:00 AM PDT



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With the S&P 500 at new highs, experts suggest it's a good time to hedge against potential downside.

Market risks include high valuations, concentration in the

- **Magnificent 7, and more.**

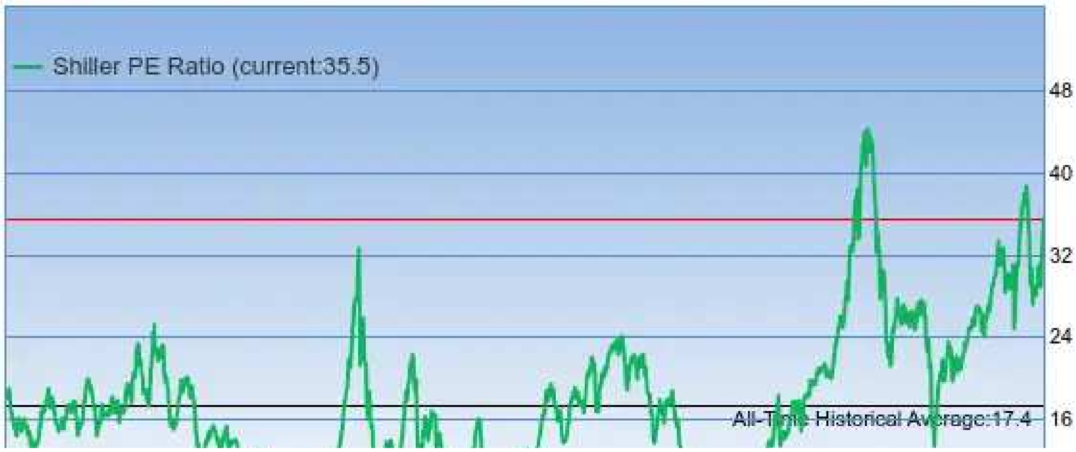
- **Hedging strategies include reducing market exposure, buying the VIX, buying puts, or writing calls.**

Stock-market downside? Never heard of it.

With the S&P 500 up 32% over the last 12 months as investors celebrate strong economic data and AI innovation, it can be easy to forget that stocks go down, too.

But with the market at an all-time high, now is probably a good time to hedge against potential downside, experts say. That's especially the case because there's an elevated degree of risk facing stocks, and the cost of some insurance measures is historically cheap.

Let's start with the risks to the rally. For starters, valuations are historically high. Here's the Shiller cyclically adjusted price-to-earnings ratio, for example. The measure is a rolling 10-year average. Valuations are most relevant for long-term investing outcomes, but a historically expensive market can become a short-term risk if the right catalyst comes along.



GuruFocus

Then there's the concentration in the market's seven largest stocks by market cap — Apple, Nvidia, Microsoft, Tesla, Alphabet, Meta, and Amazon. The seven stocks make up around 30% of the index, and the group is considered the most crowded trade in global markets, according to Bank of America's Fund Manager Survey. When investors pile into the same investment, it can increase the downside risk of the trade when they eventually move money elsewhere.

Bank of America

"This type of concentrated leadership rarely lasts. So if you're a student of history and look back across geographies and across time, it's really hard to grow at very outsized levels when you're as big as these companies are," said Jim Smigiel, the CIO at SEI, which manages $1.4 trillion. "And I don't see why that calculus should change in an AI world. I don't see that being entirely different from the advent of the internet or the automobile for that matter."

Then there's the level of interest rates, which are higher than they've been in over two decades. Elevated interest rates are meant to slow demand from consumers and businesses, allowing price growth to ease up. But the longer rates stay elevated, the bigger the risk they become to the economy.

The Fed started their hiking campaign in early 2022 and raised rates at a record pace from near 0% to more than 5%.

St. Louis Fed

Inflation has also proved to be slightly sticker than the Fed would like, and it could stay that way, prompting the central bank to leave rates higher for longer. That would, in turn, put the economy at a greater risk of recession. Higher inflation could cause long-term bond yields to rise further, according to Phillip Colmar, a partner on the global strategy and fixed income team at MRB Partners. On the other hand, rate cuts that come too soon could cause inflation to flare up again, Colmar said. Colmar's base case is for inflation to stay well above the Fed's long-term target of 2%.

Geopolitical tensions are also hot as conflict continues between Ukraine and Russia and Israel and Palestine. The feuds have so far impacted the global economy by sending food and energy prices soaring, and by threatening the route of trade through the Red Sea and Suez Canal as Houthi Rebels attack container ships in support of Palestine.

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The S&P 500 also looks overextended on a technical basis, according to many measures.

One example of this overextension is the S&P 500's price versus its 200-day moving average. David Rosenberg, the founder of Rosenberg Research, said in a recent client note that the index's price is 14% above its 200-day moving average, which is higher than 93% of the time in history.

Rosenberg Research

"The definition of a stretched market is one when the S&P 500 gaps 14% or more above the 200-day trendline. That is extreme. Beyond extreme, in fact — back to 1928, the S&P 500 has only drifted this far above the moving average 7% of the time," Rosenberg said.

Many of these risks have existed for months, if not years, by now, and stocks have continued to surge regardless. And that could continue. But for investors interested in insurance for their portfolio, experts shared the following tips below.

4 hedging strategies

The most simple strategy for hedging downside risk is **selling a portion of your holdings** to lock in profits made thus far, said Steve Sosnick, the chief strategist at Interactive Brokers.

Another way of buying insurance on the market, according to Smigiel, is **buying the CBOE Volatility Index**. A common way of doing this is buying the iPath Series B S&P 500 VIX Short-Term Futures ETN (VXX), the biggest ETF by assets under management that tracks the index. Right now, the index is just under 13, which is historically low. For instance, the index climbed as high as 66 in March 2020 and was frequently in the 20s and 30s in 2022, when the S&P 500 fell as much as 25%.

Markets Insider

The index is essentially a measure of the implied volatility of the S&P 500 over the following 30 days based on options market activity. If more investors are buying puts, which are options trades that pay off when the market falls, the index tends to rise because of the heightened bearishness among investors. In one sense, buying the VIX is like buying a stock or an ETF — investors profit when it goes up. But they also lose if volatility doesn't increase.

"We're in an election year, we're at an inflection point in monetary policy, we still have inflation over 3%, we have three wars going on, including a hot one in the Middle East that's shutting down supply lines, and the VIX has a 12 handle. That feels low," Smigiel said. "So for those that can, the market is giving you an opportunity to buy relatively cheap protection. And we're happy to buy that."

Of course, one could also just **buy put options**, Sosnick said. Put options on an index allow investors to hedge downside risk by giving them the option to sell the index at a future date at a set price. If the index falls substantially over the period of the option contract, the seller doesn't have to take on that loss. If the index stays relatively flat or rises, the investor loses the premium paid.

"Right now, honestly, puts on major indices are about as cheap as they've been relative to calls — the cost to hedge has been about as cheap as it's been in years," Sosnick said.

Sosnick also said that investors could look at writing call options themselves on an index they own. For example, if you own the S&P 500 and you sell a call option on it, you would keep the premium — the cost of the option — if the index doesn't rise. If the index does go to in-the-money territory, you lose money on the option you sold, but you also enjoy the gains of the index by owning it yourself.

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