The Strategic Use of Options and Futures in a Portfolio
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Michael Parks, CMT

- 21 years in the financial industry
- 10 years as an Investools Instructor
- Previously assisted high net-worth clients with portfolio allocation strategies
- Teaches how to trade stocks, options, and futures
- CMT (Chartered Market Technician)
Today’s Goals

- Help prepare for the next market correction.
- Examine the frequency of market drops.
- Determine possible steps you can take to hedge your portfolio.
- Learn how to help protect your account with options.
- Learn how to help protect your account with futures.

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How did your portfolio perform through the last market drop?
## Frequency of Market Declines

### A History of Declines (1900–December 2014)

<table>
<thead>
<tr>
<th>Type of Decline</th>
<th>Average Frequency¹</th>
<th>Average Length²</th>
<th>Last Occurrence</th>
<th>Previous Occurrence</th>
</tr>
</thead>
<tbody>
<tr>
<td>-5% or more</td>
<td>About 3 times a year</td>
<td>46 days</td>
<td>December 2014</td>
<td>October 2014</td>
</tr>
<tr>
<td>-10% or more</td>
<td>About once a year</td>
<td>115 days</td>
<td>October 2011</td>
<td>July 2010</td>
</tr>
<tr>
<td>-15% or more</td>
<td>About once every 2 years</td>
<td>216 days</td>
<td>October 2011</td>
<td>March 2009</td>
</tr>
<tr>
<td>-20% or more</td>
<td>About once every 3½ years</td>
<td>338 days</td>
<td>March 2009</td>
<td>October 2002</td>
</tr>
</tbody>
</table>

Source: Capital Research and Management Company

¹Assumes 50% recovery rate of lost value.

²Measures market high to market low.
How to Help Protect Your Portfolio from Market Drops

- Examine the frequency of market drops.
- What happened to your account during the past market correction?
- Did you feel the pain of loss in your portfolio?
- Are you prepared for the next market correction?
- What amount of your account do you want to hedge?
- Choose between either using options or futures to potentially hedge?

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Hedging Your Portfolio

- Purpose
  - Help reduce risk
  - Potentially improve overall returns

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Five Steps to Hedge Your Portfolio

1. Trim
2. Beta weight
3. Decide how much to hedge
4. Decide on the approach
5. Execute your plan

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Step One: Trim

- Balance your portfolio to your liking for a correction.
- Do not become overweight in any one stock.
- Take profits on some stocks or perhaps tighten stops.
- This accomplishes two things:
  1. Reduces the hedge cost (less to hedge)
  2. Have cash to buy stocks on the market dips
Step Two: Beta Weight

- Beta weight your portfolio

- Purpose:
  - This expresses your portfolio in equal units.
  - It takes apples and oranges and makes them all equal to bananas.

- SPX example

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Step Three: Decide How Much to Hedge

- Minimize costs
- Choose your hedge amount
- Today’s example: Hedge half the number of deltas
Step Four: Decide on the Approach (Options example)

- Select duration of time for options protection (40 to 100 days).
- Select strike price near .30 delta.
- Compare cost ATM to .30 delta.
- Effectiveness versus cost.
- Can sell calls to reduce cost of puts.
- Place trade.
- Remove options trade if you see risk is over.
- Note: requires account with proper options approval

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Step Five: Decide on the Approach (Futures example)

- Beta weight to /ES.
- Hedge half of portfolio after you beta weight the portfolio.
- Use buy stops for exits on futures.
- Compare options hedge to futures hedge as well as risk and cost.
- Note: requires account with proper futures approval.
Goals Recap

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