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A Fidelity Investments Webinar

Introduction to Hedging

BROKERAGE: OPTIONS

Why Hedging?

Execute an
Effective Hedge

Learn the
Hedging Basics

Agenda

Why Hedging?

What Is Hedging?

Hedging is protecting a security and/or a portfolio to minimize the impact of an adverse move.

Remember

Hedging is not the same as speculation. It is used to protect from—not profit from—an adverse price move.

Why Do Traders Hedge?

- Concern about recent volatility, but still bullish
- Overall market or sector weakness
- Shift in fundamental information that causes some concern
- Technical analysis is providing possible bearish signals
- Tax situation is not favorable to liquidate

Order Types Used to Manage Equity Positions

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Before you consider hedging, think about an exit strategy.

Stop loss

Dormant market order until triggered by last trade at or below the defined price (viewed by the market)

Stop limit

Dormant limit order until triggered by last trade at or below the defined price (viewed by the market)

Trailing stop loss

Moving dormant market order where the trigger/stop is defined by a percentage or specific amount from the defined trigger (last, bid, ask) (in house)

Trailing stop limit

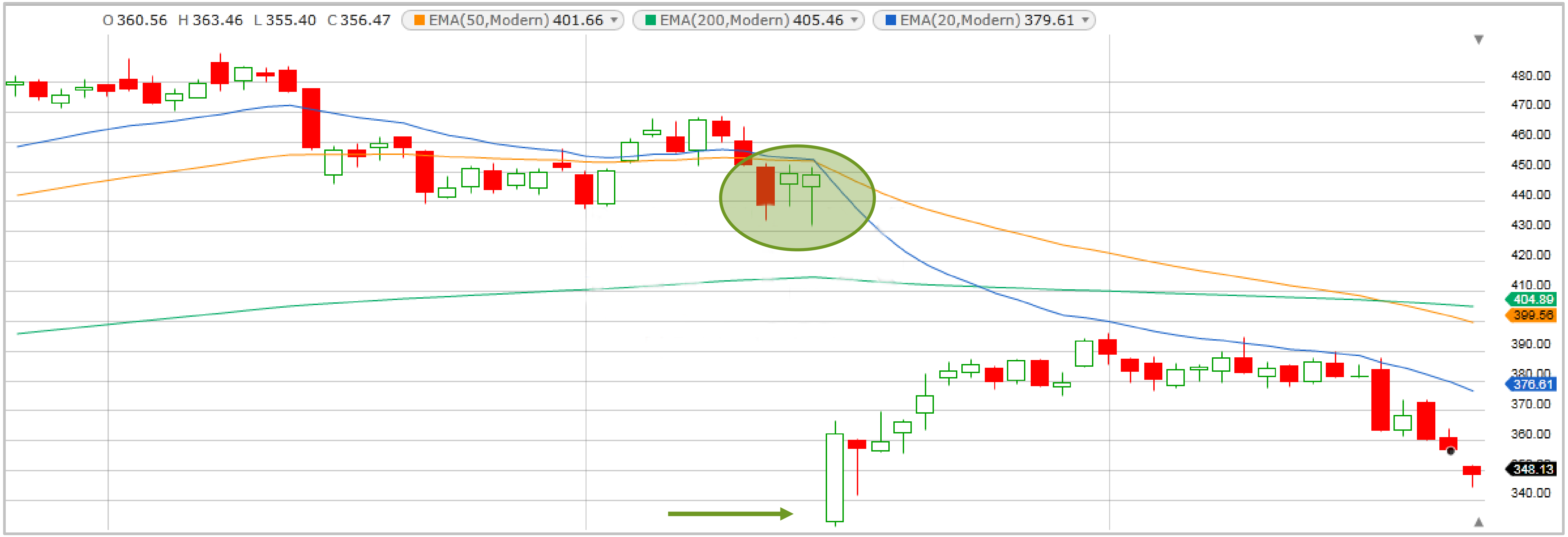
Moving dormant limit order where the trigger/stop is defined by a percentage or specific amount from the defined trigger (last, bid, ask) (in house)

Conditional orders

These orders can also be used and triggered based on any number of criteria

Enemy of Stop Orders: Gapping Risk

Security gapping can cause a result very different from the intent of the stop order.



 The Active Trader Pro® screenshots are for illustrative purposes only.

Hedge Characteristics

Advantages:

- Low cost (commission)
- Automatically closes the position
- Disciplined trading process reduces emotional decisions
- Attaches price or percentage to define loss threshold
- Exit position when important support/resistance level breached

Disadvantages:

- Gapping risk (for stop orders)
- Order never executes because the security continues to move (stop limits)
- Liquidate at unfavorable time (tax situation, trigger too close)

Learn the Hedging Basics

What Is a Hedge?

Hedging can be anything that gains value as the position you are concerned about loses value.

A true hedge defines the potential loss on a long position.

Remember

The more separation between the position of concern and its hedge, the less effective the hedge will be.

Popular Ways to Hedge

1

Using put contracts on individual positions

2

Using puts on an index as a proxy for a portfolio or a subset of a portfolio

3

Going long on securities that have a history of moving in the opposite direction of the position

Buying Puts to Protect Position

How does buying puts protect your position?

- Premium is spent to pay for protection on security or index
- Puts increase in value when underlying decreases in value
- Hedge begins at the breakeven of puts (strike minus premium paid)

Buying Puts to Protect Position

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Advantages:

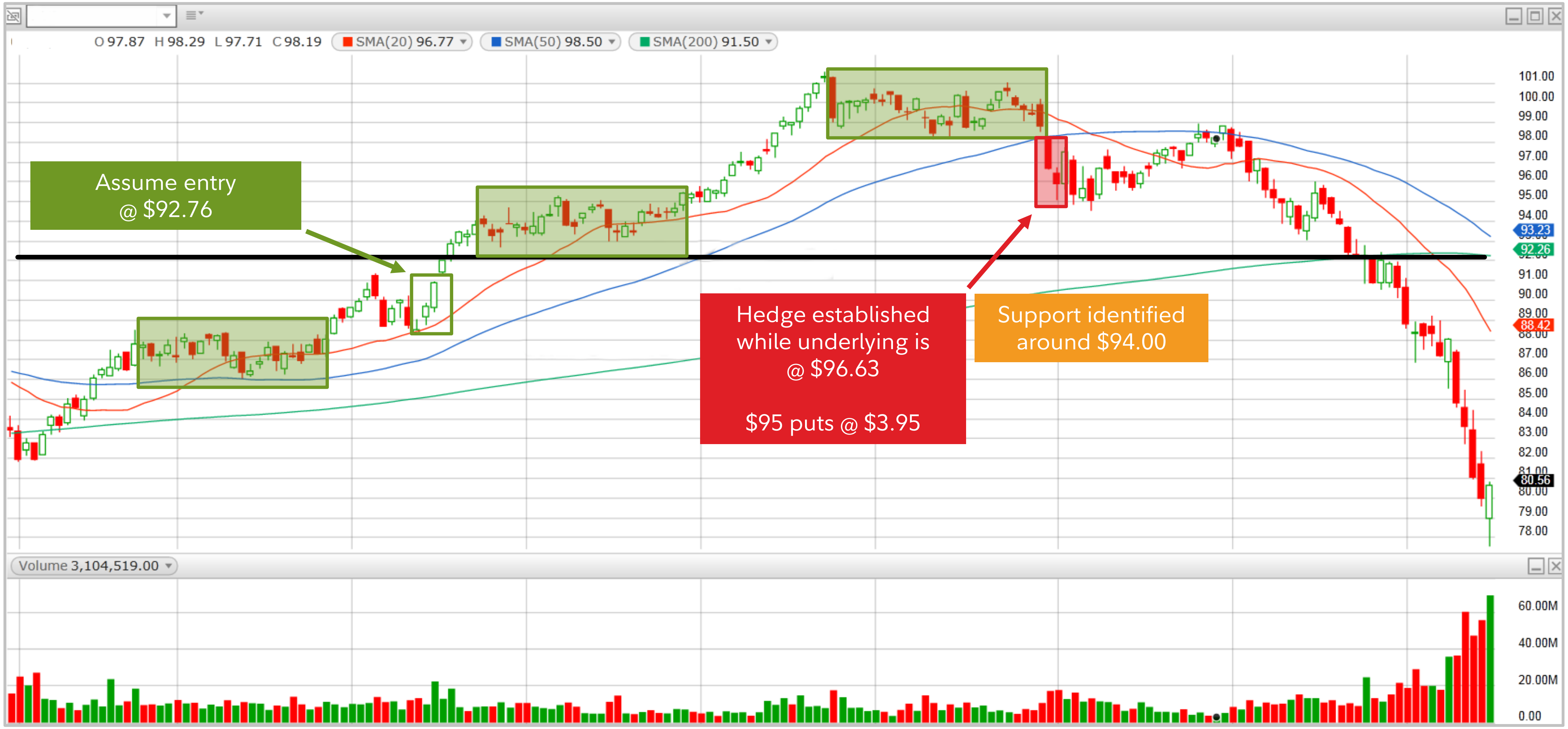
- Acts as a true hedge
- The contract holder controls if/when the contract is exercised
- Allow more flexibility for managing individual tax situations
- No gapping risk while the hedge is on

Disadvantages:

- Cost to establish and manage increases breakeven on the position
- Often costs more when the true "need" arises
- Time to manage
- Requires an understanding of a more complex financial instrument

Execute an Effective Hedge

Buying Puts to Protect Position



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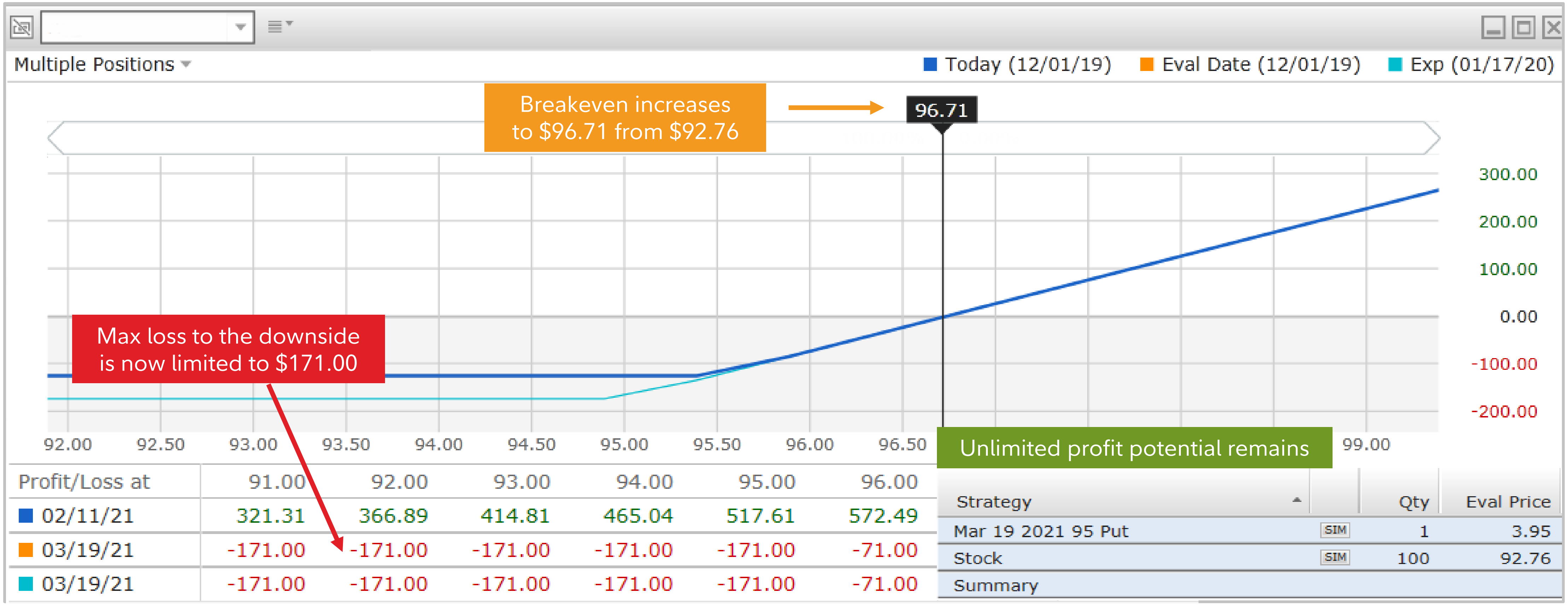
Buying Puts to Protect Position

Buying at-the-money protective puts defines the loss on the position



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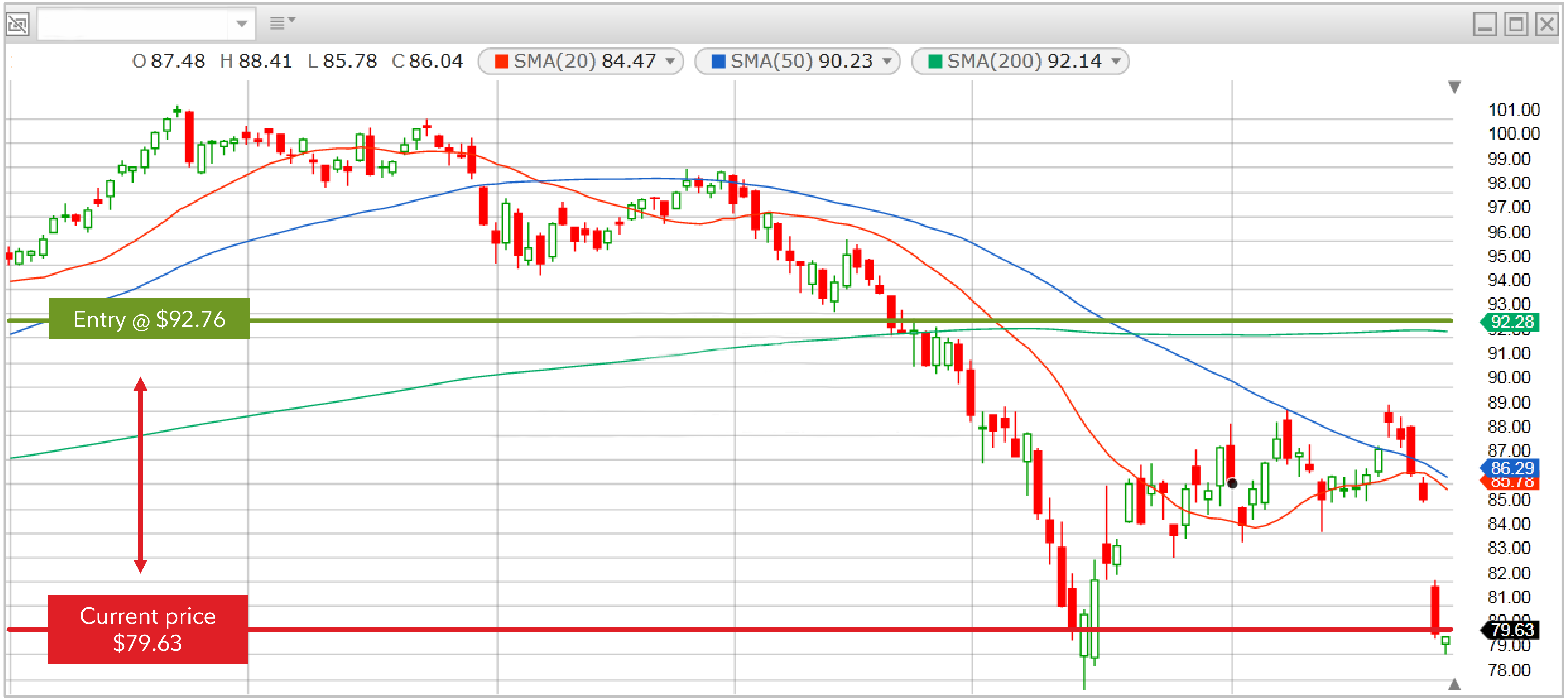
Buying Puts to Protect Position



Hedged Position:
Loss Limited to $171

Unhedged Position:
Loss of $13.13/share = $1313 total loss

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Buying Puts to Protect Portfolio

Buying puts for individual positions is expensive and time-consuming to manage.

For larger portfolios, some traders will use puts on an **index** or an **ETF** as a hedge

- Most common index or ETF used to hedge portfolios is the S&P 500® (SPY, IVV) – other indexes may be more appropriate depending on the portfolio
- Not exact, risk of tracking error

Remember

If using index or ETF put contracts, consider the differences in exercise style and deliverable on the contracts.

Buying Puts to Protect Portfolio

To calculate the number of contracts needed, take the current value of target asset to hedge divided by total notional value that the puts cover (usually strike price * 100).

Example

At the time of this writing, the S&P 500® was at 3000.

Each at-the-money contract covers $300,000 (3000 * 100).

A closely correlated $1,200,000 equity portfolio could be hedged with four puts on the index.

What Is Beta?

Beta measures the sensitivity of a price change of an underlying compared to a benchmark.

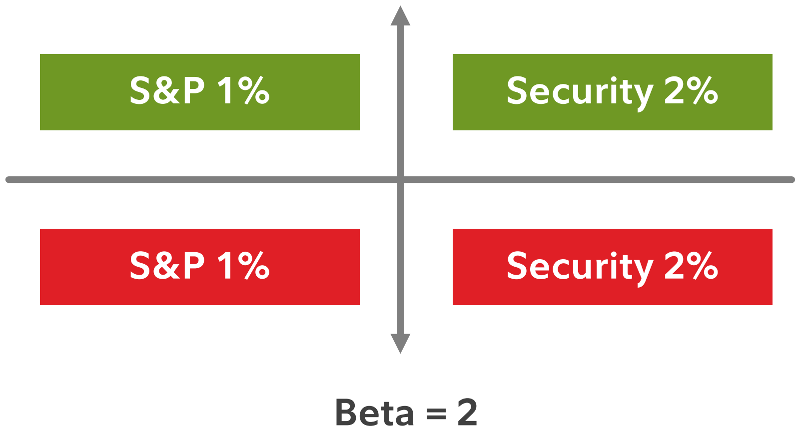
A beta of 1.00 means the assets' prices move together.

Beta weighting allows a trader to adjust the hedge to become more effective.

- The most common benchmark is the S&P 500, but beta weighting can be done between any two assets.

Remember

Beta is not a static measure; it is constantly changing.



What Is a Collar?

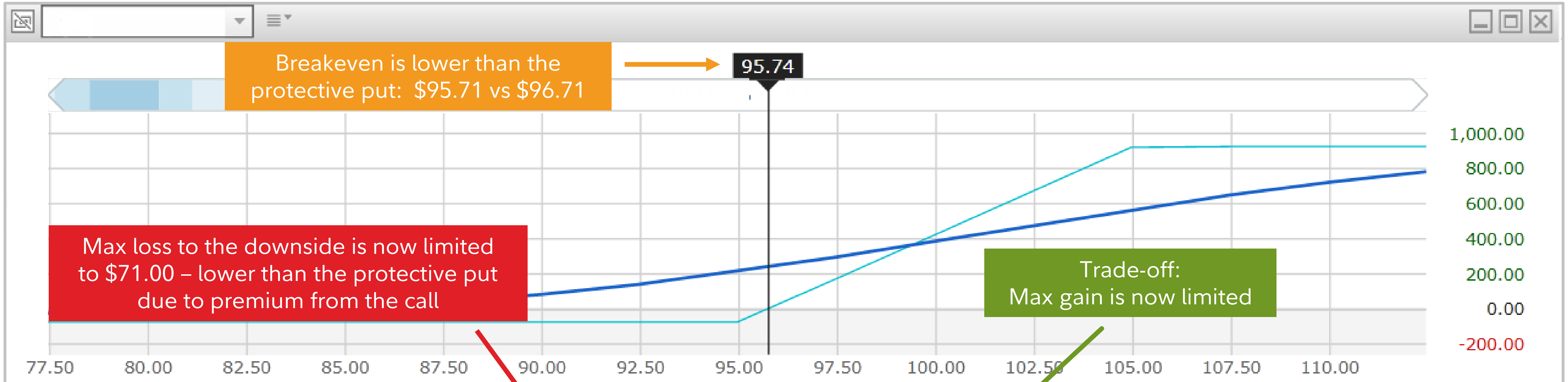
Buying a protective put and reducing the cost by selling an out-of-the-money call.

A collar limits upside gain, but reduces the cost of the hedge.

Remember

A put spread can be used to reduce the cost of the protective put, but it only protects the position down to the short strike.

Buying a Collar



Profit/Loss at	80.00	85.00	90.00	95.00	100.00	105.00	110.00	115.00	120.00	125.00	130.00
02/11/21	56.39	150.97	269.49	400.02	528.37	642.44	734.97	804.13	852.04	882.94	901.52
03/19/21	-71.00	-71.00	-71.00	-71.00	429.00	929.00	929.00	929.00	929.00	929.00	929.00
03/19/21	-71.00	-71.00	-71.00	-71.00	429.00	929.00	929.00	929.00	929.00	929.00	929.00

Strategy		Qty	Eval Price
Mar 19 2021 105 Call	SIM	-1	1.00
Mar 19 2021 95 Put	SIM	1	3.95
Stock	SIM	100	92.76
Summary			

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Review: Introduction to Hedging

	STOP ORDERS	PROTECTIVE PUTS	INDEX PUTS	COLLARS
COST	Sale price can be lower than the current price	Most costly on an individual position basis	Usually less costly than buying individual positions	Selling the call reduces the cost of the hedge
UPSIDE	Unlimited	Unlimited	Unlimited	Limited
EFFECTIVENESS	Does not serve as a true hedge	Most effective due to direct relationship with the underlying	Effectiveness will vary depending on the correlation between the index and the stock portfolio	Most effective due to direct relationship with the underlying
EASE OF MANAGEMENT	Dependent on the number of positions, the effort required could vary from little to significant	May require significant time and effort to manage	Generally requires the least time and effort to manage	May require significant time and effort to manage

Key Takeaways

- Hedging is done to minimize the impact of an adverse move.
- Stop and trailing stop orders can help manage risk for the cost of a commission, but do not serve as a true hedge.
- Protective puts serve as an effective hedge, but at the cost of the premium.
- The stronger the relationship between the hedge and the asset it is intended to protect, the more effective the hedge will be.
- Collars allows for more cost-effective hedges, but at the cost of upside potential.

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There are additional costs associated with option strategies that call for multiple purchases and sales of options, such as spreads, straddles, and collars, as compared with a single option trade.

Trailing stop orders may have increased risks due to their reliance on trigger pricing, which may be compounded in periods of market volatility, as well as market data and other internal and external system factors. Trailing stop orders are held on a separate, internal order file, place on a "not held" basis and only monitored between 9:30 AM and 4:00 PM Eastern.

Stop loss orders do not guarantee the execution price you will receive and have additional risks that may be compounded in periods of market volatility. Stop loss orders could be triggered by price swings and could result in an execution well below your trigger price.

Trailing Stop orders are monitored between 9:30 AM and 4:00 PM Eastern Standard Time and are maintained on a separate order file on a “not held” basis until triggered, at which time they are sent to the marketplace. Additional information about Trailing Stop orders is available at Fidelity.com. ATP: Active Trader Pro® is available to customers trading 36 times or more in a rolling 12-month period.

Technical analysis focuses on market action — specifically, volume and price. Technical analysis is only one approach to analyzing stocks. When considering which stocks to buy or sell, you should use the approach that you're most comfortable with. As with all your investments, you must make your own determination as to whether an investment in any particular security or securities is right for you based on your investment objectives, risk tolerance, and financial situation. Past performance is no guarantee of future results.

Important Information, cont'd.

Examples in this presentation do not include transaction costs (commissions, margin interest, fees) or tax implications, but they should be considered prior to entering into any transactions. There are additional costs associated with option strategies that call for multiple purchases and sales of options, such as spreads, straddles, and collars, as compared with a single option trade.

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Fidelity Brokerage Services, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917

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