How to Safeguard Your Wealth Using the VIX and Other Advanced Strategies of Elite Investors

Money & Markets
PRECISION PROFITS

The *Precision Profits* Guide to "Portfolio Insurance":

How to Safeguard Your Wealth Using the VIX and Other Advanced Strategies of Elite Investors

By Michael Carr

WE insure ourselves against many of life's risks…

But sometimes we don't think about what we're really insuring.

In addition to providing coverage for damage that, sooner or later, is likely to occur, almost every form of insurance also protects our *wealth*.

We buy car insurance to repair our car if it gets damaged—but also to protect our wealth by avoiding costly mechanic bills.

Many of us have homeowner's insurance to repair our property after an accident or extreme weather—but it also protects our wealth if we're suddenly faced with an outsized expense.

Health insurance protects our wealth against large medical bills…

Disability insurance protects our wealth against debilitating illness or accidents…

Life insurance protects our wealth against the loss of a primary income provider…

And so, whether we realize or not, in addition to our health, homes, and cars, insurance also safeguards our money.

However, when it comes to our *portfolios*, few investors take precautions against a risk that is guaranteed to occur…

A bear market.

Can you obtain insurance for this? You can.

There are a variety of ways to acquire "portfolio insurance" — and you'll learn about all of them in this report.

Just like other forms of insurance, each has their pros and cons. So you'll have to decide what's right for you.

But if you think a bear market is on the horizon, and you want some peace of mind and want to protect your investments from a plunging stock market, here are three ways that you can do just that.

Portfolio Insurance Strategy #1: Put Options on ETFs

The first way to insure your portfolio against losses is with put options on ETFs that track broad indexes.

Because put options increase in value as the price of the underlying ETF decreases in value, they can offer substantial insurance against a market decline.

So if you have a diversified portfolio, you can protect it by, for example, purchasing puts on the SPDR S&P 500 ETF (NYSE: SPY). This put option would rise in value as the S&P 500 falls. (If you're brand-new to trading options, make sure to read this guide before diving in further so you have a grasp of the fundamentals.)

You could buy a put expiring in about six months to provide protection against a large loss—or you can use puts expiring in shorter or longer timeframes for protection as well. It really depends on when you think a bear market is going to occur.

Used this way, you can think of the cost of the put as the "insurance premium."

If the market suffers a big loss, the insurance pays off. If that doesn't happen, your option loses value.

The drawback of this strategy, however, is that it can be expensive. You could expect to pay more than 5% a year to protect your portfolio. So if you have a $100,000 portfolio, the cost of insurance is likely to average $10,000 a year.

Let's look at how that works. With the SPDR S&P 500 ETF Trust trading near $450, you could buy a $405 put expiring in six months for about $1,300. You would need two of these to protect your portfolio since that would cover about $90,000 worth of stock. That still leaves 10% of your portfolio unhedged.

You would have to buy these options twice a year. That's $5,200 a year for the options.

If the S&P 500 declines at least 10% before the option expires, then you can collect a profit on the trade to offset losses in your portfolio.

But the downside is options also expire. So if the market hasn't fallen by the time the option expires, you'll have to purchase another option(s) if you wish to extend your coverage.

How can you mitigate this?

Really, it's to be more *targeted* in the type of puts you buy.

We've already mentioned one way of doing this above, i.e. to purchase put options where the expiry is more aligned with when you think the bear market is going to occur.

Basically, the more accurate your forecast, the cheaper it's going to be to buy the put option.

The more accurate you are, the more likely you are to buy the puts near the top. Puts generally cost less when prices are rising and could be expected to be cheapest near the top. That's because implied volatility tends to decline as prices rise, and that's an important factor in options pricing.

In addition to timing, the accuracy of the forecast can allow you more precisely target the drawdown. That allows you to determine the "best" option and avoid overpaying for a suboptimal put option.

Another approach would be to use different options strategies to protect smaller amounts of your portfolio. This will hold costs of insurance down but obviously this exposes your overall portfolio to greater losses when the market does decline.

So for those inclined to insure their portfolio against a market downturn without using options, there are other techniques to consider…

Portfolio Insurance Strategy #2: Inverse ETFs

Today, there are ETFs for virtually any market sector you can think of. There are ETFs for tech stocks and value stocks, gold and oil, cryptocurrencies, and even things like coffee beans and corn.

But what many don't know is that there are ETFs designed to profit even as the market falls. These are called inverse ETFs—and you can use them to protect against market risks.

By holding inverse ETFs in your portfolio, you're effectively holding an insurance policy against the market. Because even as the rest of your portfolio falls, this holding should rise in value.

That's why trading inverse ETFs, such as the ProShares Short S&P 500 ETF (SH), can be a viable alternative.

While these securities don't expire like options, it's important to understand that, like options, they don't make for the best long-term buy-and-hold investments.

Why's that?

Because inverse ETFs rebalance each day. This makes their long-term returns dependent on the sequence of returns.

Fund managers will reset the fund every night to match the next day's gains and the ETF will not track the index over the long term. This can result in the ETF not matching the move of the index it's based on 1-to-1.

For example, in early March, the S&P 500 Index was down 12.6% since the beginning of the year. An inverse fund tracking the index was up 12.9%, a happy accident where the fund outperformed its benchmark.

A leveraged fund seeking to deliver twice the change in the index was up 26.7%. That's 1.5% better than expected — a tracking error of 6%. The leveraged fund that moves 3 points for each 1-point move in the S&P 500 gained 46.9%. That's a 24% tracking error compared to the expected return of 37.8%.

Had the sequence of daily changes been different, the tracking errors could work against traders. This is why inverse funds are for *trading*—not buying and holding.

Now, if you're looking for a more advanced form of portfolio insurance—one that could potentially be much more profitable in a bear market—read on…

Portfolio Insurance Strategy #3: ETNs that Track the VIX

The third way to insure your portfolio is with an ETN that tracks volatility.

The most well-known measure of volatility is the CBOE Volatility Index (or the VIX for short). The VIX is often called the "fear gauge" because it rises when the stock market falls.

VIX measures premiums on options contracts tied to the S&P 500. Because investors tend to buy puts in market declines, those premiums rise as stock prices fall. This buying activity, then, pushes up the premiums—and therefore the VIX.

On average, VIX tends to move up about 4% when the S&P 500 drops by 1%.

In especially volatile markets, VIX moves substantially more than that. In the first months of 2022, VIX rose 90% as the S&P 500 dropped 12%.

VIX cannot be traded directly, but there *are* several exchange-traded notes (ETNs) that track VIX.

ETNs are similar to the more familiar exchange traded fund (ETF) except that ETNs hold derivatives rather than shares of stock like ETFs do.

iPath S&P 500 VIX Short-Term Futures ETN (NYSE: VXX) is among the largest VIX ETNs. During the recent market decline, VXX gained 36%, less than half as much as VIX but about three times the size of the move of the S&P 500, in line with historical averages.

What you can do, then, is:

1. Buy VXX itself; or
2. Buy call options on VXX to trade increased volatility

Of course, there is risk in any trade, but volatility could be a suitable trade for aggressive investors.

Defend Your Wealth Like an Elite Investor

As with any insurance, the time to buy protection is before you need it.

That means now is the time to define how you will insure your portfolio before the next bear market hits.

I believe using a short-term strategy is often the best defense in a bear market and the best offense in a

bull market. And to hedge against bear market risks, this may include incorporating inverse ETFs, using put options on ETFs that track indexes or trading VXX.

Of course, it's important to select the "portfolio insurance" that you feel most comfortable working with.

Shielding our portfolio with strategies like these will not only help us stay prepared, but will also give you peace of mind for when the next market risk strikes.

Regards,

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