Getting on the right side of the fence

As an equity investor, you have two options: passive investing (Exchange Traded Funds [ETF]) or active investing (stock-picking).

We will quickly unpack these options and then discuss hedging; which can be simply described as how to reduce the risk of losing money.

PLAYING IT SAFE AND TAKING A RISK

An ETF is a large collection of shares (and other asset classes such as bonds and cash) that are combined in a single financial product. You do not view the underlying assets, just the total combined value.

As ETFs are diversified, changes in value are usually small over any short period.

Stock picking means choosing individual companies in which to invest. Generally, stock-pickers do not diversify too much, otherwise they may as well have bought an ETF.

PLAYING BOTH SIDES

In an episode of the series Billions, Chuck Rhodes (played by actor Paul Giamatti) succinctly summed up stock picking as trying to maximise gains while minimising downside risk. Hedging is exactly that; trying to minimise potential losses.

Professional stock pickers use a variety of tools to hedge risks. However, these are complex, expensive and require good timing. We will ignore these for today.

Everyday investors tend to hedge their portfolios through simpler mechanisms. Through diversification, ETFs offer a natural hedge. Because there are many assets included in an ETF, a loss of value in one stock does not devalue the ETF significantly.

Think about Steinhoff, an ETF that included Steinhoff as 1 of 200 underlying instruments would have lost 0.5% overall. A stock picker who possibly only invested in Steinhoff would have lost 95% of his investment.

An ETF may also include exposure to physical retail and online retail stocks. The loss in value of physical retailers may be counteracted by gains of online retailers over time. This is a prime example of a natural hedge.

BE SELECTIVE

A stock picker may gain by being selective and investing only in online retail stock. If the brick and mortar retailer lost 20% over the period, and online retailers gained 20%, the ETF investor is in a neutral position (nett 0) this is effectively hedged without any gain. The stock picker who owns only online retail shares will be up 20% over the same period.

Great for the stock picker, right? Not if one of the shares was Steinhoff. It is impossible to know before-hand that the company was built fraudulently. When exposed, Steinhoff shares plummeted 95% and have not recovered. This is the risk active investors face.

SIGNIFICANT INVESTMENT

Therefore, hedging using financial instruments requires technical knowledge and is costly. Stock-picking without hedging can be Steinhoff-grade risky. Does this leave only ETFs and the concomitant limited returns for the lay investor?

No, as an ordinary investor who is a stock picker, there was previously not much you could do. Now there are products which provide protection from losses that are caused by the management of a company who are misleading investors.

A LONG ROAD TO RECOVERY

In an example of two identical portfolios of five equally weighted shares, an investor who experiences a Steinhoff-type loss would take 23 years to catch up to the performance of the identical protected portfolio (due to the small insurance cost on the insured portfolio).

That is assuming that there are no more loss events during that time. That is 23 years of performance that has been saved simply by hedging risk.

South African investors can buy certain products that will protect their investments for 0.60% of the value insured. This will provide annual coverage against any losses caused by management fraud. So, whether you invest in individual stocks or ETFs, hedging options exist. With ETFs you do not have to do anything, the hedge is built in for you.

Shane Curran
MD
InvestSure Technologies

"As ETFs are diversified, changes in value are usually small over any short period."