

Portfolio Insurance

Buy low, and sell high. It is easier said than done. Many people have done very well in the stock market recently, and are wondering how to preserve the gains without throwing in the towel and leaving what is a very strong market. Is it possible to significantly reduce risk without selling a significant portion of your stocks? The answer is portfolio insurance. This is similar, in theory, to the risk management products that your insurance agent already sells to you. Brokers and investment advisors know this as hedging. If you own a car you must pay liability insurance to protect your assets in case you run over somebody. If you own a house you must pay homeowners insurance to protect yourself in the event of a fire, your roof blowing off, someone getting injured on your property or even a plane hitting and destroying your home. You pay for this insurance, not because these are likely events, but to protect your hard earned assets from that unlikely but possible disaster. Now ask yourself, what is the likelihood of the stock market going down 10, 20 even 40 percent? This is much more likely, in fact, it occurs frequently. The recent rise in the stock market indexes has created a perception that the markets are generally bulletproof. While history has proved this is true over very long stretches of time, there are adjustment periods between these long term bull markets that generally last between 8 and 16 years where returns have been flat to negative. If you started investing in stocks in 2002 or 2003 you have done quite well, but if you started investing in 1999 or 2000 it hasn't been a very good run. The S&P 500 as of today is still below its September 2000 high. The S&P 500 was down 43 percent from September 2000 to July 2002. In 1998 there was a 22 percent drop, in 1991 there was a 20 percent drop, and in 1987 there was a 33 percent drop in the S&P 500 index. In order for a portfolio to recoup a 43 percent loss it has to go back up over 75 percent just to make back the money lost. For those with an appreciable portion of their assets in the stock market, these events were major financial setbacks. These events do happen with regularity. You pay the insurance companies to protect you against events that, the odds are, probably won't happen. It would make sense, if you can do it, to protect your savings from the inevitable downturns in the market.

Over the last couple of years electronic account and market access have made the application of this type of strategy relatively simple. Market innovation has empowered investors making it easier and cheaper to buy and sell exchange traded financial products. All advisors and brokers are required to know about the basic use of these investment tools. A majority don't bother to apply these simple, effective strategies to client portfolios. In fact, with a diversified portfolio of individual stocks or exchange traded funds (ETF's), one can use a covered call strategy to generate more than enough additional income, on the stocks that you already own, to pay for the portfolio insurance (hedge) to guard against a drop in the market of 5 percent or more. In effect, one can generate additional income and protect the portfolio for free. It can be described as free stock market insurance with a 5 percent deductible. There are a number of ways to hedge different portfolios and there are varying degrees of protection. You just need one of the few brokers or advisors that are willing to do this for you. Ask your broker or advisor why they have not offered this strategy to you, when the benefit to your financial security is obvious. I am not sure that there is a good answer to that question.